RBS Holdings N.V.
Form 20-F
April 30, 2014

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 20-F

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

OR

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

For the fiscal year ended December 31, 2013

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

OR

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

Commission file number: 1-14624

RBS Holdings N.V.

(Exact name of Registrant as specified in its charter)

The Netherlands

(Jurisdiction of incorporation)

Gustav Mahlerlaan 10, 1082 PP Amsterdam, The Netherlands

(Address of principal executive offices)

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

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

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

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

*** The guarantee is not listed for trading, but is listed only in connection with the registration of the corresponding Non-cumulative Guaranteed Trust Preferred Securities of

RBS Capital Funding Trust VII.

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

None

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

None

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

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

RBS Holdings N.V.

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

¨ Yes x No

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

¨ Yes x No

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

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

x Yes ¨ No

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

¨ Yes ¨ No

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

Large accelerated filer ¨ Accelerated filer ¨ Non-Accelerated filer x

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

¨ U.S. GAAP

x International Financial Reporting Standards as issued by the International Accounting Standards Board

¨ Other

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

¨ Item 17 ¨ Item 18

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

¨ Yes x No

Form 20-F

SEC Form 20-F cross reference

SEC Form 20-F cross reference

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Chairman's statement

Five years ago The Royal Bank of Scotland Group plc (“RBSG”) embarked on a strategic restructuring designed to correct the aspects of its business that made it particularly vulnerable to the financial crisis of 2008. The execution of that restructuring has transformed the financial position of RBS Group: the balance sheet has been reduced by more than £1 trillion, and it has repaid hundreds of billions of Government funding support and removed the imminent threat that its size, risk and complexity posed to the UK economy.

In 2013, further steps were taken to resolve remaining legacy balance sheet issues by announcing the creation of RBS Capital Resolution Group, with the aim of accelerating the removal of these legacy assets and releasing the capital they are still tying up. With the creation of the RCR, RBS Group has announced its aspiration to remove all of these assets from its balance sheet in three years. RCR commenced on 1 January 2014 with an initial pool of c. £29 billion of assets, of which £1.5 billion related to RBSH Group. RBSH Group expects to further run down or dispose substantially of the remainder of the businesses, assets and portfolios previously managed under its Non-Core division and not transferred to the RBS Capital Resolution Group.

In February 2014, RBSG announced the results of a business review which was undertaken by Ross McEwan, Chief Executive Officer of RBS Group. The outcome was that RBSG needs a strategy that will address the weakness in performance for customers, so that it can provide acceptable returns to shareholders. The business review that has been conducted revealed the key challenges of RBSG, but it has also given a clear path to improve the bank. There is now a strategy to deliver a sustainable bank with a clear ambition: RBSG wants to be number one for customer service, trust and advocacy, in every one of its chosen business areas by 2020.

Seven operating divisions will be collapsed into three customer businesses that can understand customers' needs and provide appropriate, consistent services far better than across current silos. The three customer businesses will cover Personal & Business Banking, Commercial & Private Banking, and Corporate & Institutional Banking.

Support functions will be smaller, more expert and dedicated to helping the businesses succeed for customers. Highly disciplined and well managed conduct and risk functions will maintain safety and soundness.

Only 30% of staff today deal directly with the customer. By 2017 more than half will deal directly with the customer and all staff will be measured against success in improving customer advocacy.

The announced restructure has no impact on RBS Holdings N.V.'s clients. The impact on the divisional structure of RBSH will be announced in due course.

On 19 April 2011, it was announced that a substantial part of the business activities of RBS N.V. would transfer to RBS plc. The majority of the transfers were concluded in 2011 and 2012. In 2013, the assets and liabilities relating to businesses in Russia, Korea, Romania and North America were successfully transferred. A few businesses remain, including China, India, Thailand and Indonesia. The intention is to transfer the assets and liabilities of these locations to RBS plc as well. Furthermore, as announced on 19 April 2011, RBSG is committed to provide the necessary support to ensure that RBS N.V. continues to meet its commitments during and after the transfer's.

At 31 December 2013, RBSG Group had 2,500 employees, of which 62 are employed in the Netherlands.

Results of operations in 2013

Operating loss before tax was €142 million compared with a loss of €887 million in 2012. This was largely due to decreased expenses as a result of staff transferring as part of the business transfers to RBS plc and business divestments and partly offset by lower income due to the transfers of business.

Net interest income decreased due to further transfers to RBS plc and the continued low interest rate environment, while non-interest income increased due to the lower loss on own credit adjustments.

Total equity as at 31 December 2013 was €2.9 billion, an increase of €1.1 billion compared with 31 December 2012, mainly due to increased unrealised gains on available-for-sale assets.

Capital

The RBSH Group continues to be well capitalised. At 31 December 2013, the RBSH Group's Total capital ratio was 26.1%, the Tier 1 capital ratio was 23.2% and the Core Tier 1 capital ratio was 20.5%.

Outlook

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

Also in 2014, we will continue to de-risk RBS N.V. and transfer its assets and liabilities to RBS plc.

On behalf of my fellow Managing Board members, I would like to thank all our employees and clients for their continued commitment during 2013.

Jan de Ruiter

Chairman of the Managing Board of RBS Holdings N.V.

Amsterdam, 30 April 2014

Business review

Presentation of information

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

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

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

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

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

International Financial Reporting Standards

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

Glossary

A glossary of terms is detailed on pages 198 to 203.

Forward-looking statements

Certain sections in this document contain ‘forward-looking statements’ as that term is defined in the United States Private Securities Litigation Reform Act of 1995, such as statements that include the words ‘expect’, ‘estimate’, ‘project’, ‘anticipate’, ‘believe’, ‘should’, ‘intend’, ‘plan’, ‘could’, ‘probability’, ‘risk’, ‘Value-at-Risk (VaR)’, ‘target’, ‘goal’, ‘objective’, ‘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 RBS Group’s and the Group’s restructuring and new strategic plans, divestments, capitalisation, portfolios, net interest margin, capital ratios, liquidity, risk-weighted assets (RWAs), return on equity (ROE), profitability, cost:income ratios, leverage and loan:deposit ratios, funding and risk profile; discretionary coupon and dividend payments; implementation of legislation of ring-fencing and bail-in measures; sustainability targets; litigation, regulatory and governmental investigations; the Group’s future financial performance; the level and extent of future impairments and write-downs; and the Group’s exposure to political risks, including the impact on the RBS Group of the referendum on Scottish independence, credit rating risk and to various types of market risks, such as interest rate risk, foreign exchange rate risk and commodity and equity price risk. These statements are based on current plans, estimates and projections, and are subject to inherent risks, uncertainties and other factors which could cause actual results to differ materially from the future results expressed or implied by such forward-looking statements. For example, certain market risk disclosures are dependent on choices about key model characteristics and assumptions and are subject to various limitations. By their nature, certain of the market risk disclosures are only estimates and, as a result, actual future gains and losses could differ materially from those that have been estimated.

Other factors that could cause actual results to differ materially from those estimated by the forward-looking statements contained in this document include, but are not limited to: global economic and financial market conditions and other geopolitical risks, and their impact on the financial industry in general and on the Group in particular; the ability to implement strategic plans on a timely basis, or at all, including the simplification of the RBS Group’s structure and the exiting of assets in RBS Capital Resolution; the achievement of capital and costs reduction targets; RBSH group’s reliance on the RBS Group; ineffective management of capital or changes to capital adequacy or liquidity requirements; organisational restructuring in response to legislation and regulation in the European Union (EU) and the United States (US); the implementation of key legislation and regulation including the proposed EU Recovery and Resolution Directive; the ability to access sufficient sources of capital, liquidity and funding when required; deteriorations in borrower and counterparty credit quality; litigation, government and regulatory investigations including investigations relating to the setting of LIBOR and other interest rates and foreign exchange trading and rate setting activities; costs or exposures borne by the RBS Group arising out of the origination or sale of mortgages or mortgage-backed securities in the US; the extent of future write-downs and impairment charges caused by depressed asset valuations; unanticipated turbulence in interest rates, yield curves, foreign currency exchange rates, credit spreads, bond prices, commodity prices, equity prices and basis, volatility and correlation risks; changes in the credit ratings of the Group; changes to the valuation of financial instruments recorded at fair value; competition and consolidation in the banking sector; the ability of the Group to attract or retain senior management or other key employees; regulatory or legal changes (including those requiring any restructuring of the Group's operations) in the US and other countries in which the Group operates; changes to regulatory requirements relating to capital and liquidity; the execution of the approved transfers of a substantial part of the business activities of RBS N.V. to RBS; changes to the legal recourse available to investors resulting from the legal demerger of ABN AMRO Bank N.V.; changes to the monetary and interest rate policies of central banks and other governmental and regulatory bodies; general operational risks; reputational risk; the conversion of the B Shares issued by the RBS Group in accordance with their terms; 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 announcement, and the RBSH Group does not undertake to update any forward-looking statement to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events.

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

Business review

Description of business

Introduction

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

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

RBS Holdings has one direct subsidiary, RBS N.V., a fully operational bank within RBSH Group. RBS N.V. is independently rated and regulated by the Dutch Central Bank. Certain assets within RBS N.V. continue to be owned by the Dutch State or shared by the Consortium Members.

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

*interest is held by Stichting Administratiekantoor Beheer Financiële Instellingen

RBSH Group had total assets of €39.8 billion and owners' equity of €2.9 billion at 31 December 2013. RBSH Group's capital ratios were a Total capital ratio of 26.1%, a Core Tier 1 capital ratio of 20.5% and a Tier 1 capital ratio of 23.2%, as at 31 December 2013.

Organisational structure and business overview

RBSH Group's activities are organised on a divisional basis as follows:

Markets is an origination, sales and trading business across debt finance, fixed income and currencies. The division offers a unified service to RBSH Group's corporate and institutional clients. The Markets' origination, sales and research teams build strong ongoing client partnerships, provide market perspective and access, and work with the division's trading and structuring teams to meet the client's objectives across financing, risk management, investment, securitisation and liquidity.

International Banking provides financing, transaction services and risk management. International Banking serves as the delivery channel for Markets' products to corporate clients.

Central items comprises group and corporate functions, such as treasury, capital management and finance, risk management, legal, communications and human resources.

Non-Core manages separately assets that RBSH Group intends to run-off or dispose, in line with RBS Group strategy for Non-Core assets. It also includes the remaining assets and liabilities in RBS N.V. that have not yet been sold, wound down or transferred to the Consortium Members, referred to as 'Shared Assets', in which each of the consortium shareholders has a joint and indirect interest.

Transfers of a substantial part of the business activities of RBS N.V. to RBS plc

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

During the last quarter of 2011 RBS N.V. transferred to RBS plc a large part of its UK activities including the Equities & Structured Retail, Markets, Lending and former GTS businesses as well as part of the UK Non-Core portfolio.

In the first half of 2012, assets and liabilities largely relating to businesses in Singapore, Hong Kong and Kazakhstan were transferred to RBS plc by a combination of local schemes of arrangement, novations and subsidiary share sales.

In September 2012, through a statutory demerger and cross-border merger (the "Dutch Scheme"), RBS N.V. transferred net assets of €868 million to RBS plc, related largely to Transaction Services business and Lending deals. The transferred Markets business included most Dutch, German and Italian law governed securitised products and a number of over the counter transactions.

Business review

In the latter half of 2012, other eligible businesses in the Netherlands and certain EMEA countries, and businesses in Malaysia, Turkey and the United Arab Emirates were transferred via novations, market mechanisms and subsidiary share sales.

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

RBS NV US branches

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

Competition

RBSH Group faces strong competition in all the markets it serves. Banks' balance sheets have strengthened whilst loan demand has been subdued as many customers have sought to delever and the economy has remained weak.

Competition for corporate and institutional customers in the Netherlands and abroad is from Dutch banks and from large foreign universal banks that offer combined investment and commercial banking capabilities. In addition, RBSH Group's Markets division faces strong competition from dedicated investment banks. In asset finance, RBSH Group competes with banks and specialist asset finance providers, both captive and non-captive. In European and Asian corporate and institutional banking markets RBSH Group competes with the large domestic banks active in these markets and with the major international banks.

Recent developments

Cap on variable remuneration

The fourth EU Capital Requirements Directive (CRD IV), implemented for banks in the UK by the Prudential Regulatory Authority, imposes a 1:1 cap on variable remuneration in relation to salary; however with shareholder approval it is possible to award variable remuneration up to 200% of fixed pay (i.e. a 2:1 cap).

All of the RBS Group's major competitors have indicated that they will seek approval from their shareholders to introduce a 2:1 cap and the RBS Group Board believes the best commercial solution for RBS Group would be to have the flexibility on variable compensation which is now emerging as the sector norm. This would also allow RBS Group to maintain the maximum amount of compensation that could be subject to performance conditions including claw back for conduct issues that may emerge in future.

On 24 April UKFI informed the RBS Group board that it would vote against any resolution which proposes a 2:1 ratio. In these circumstances, the RBS Group Board expects that such a resolution would fail and will therefore not be brought to the Annual General Meeting. HM Treasury has commented that it considers an increase to the cap on variable remuneration cannot be justified whilst RBS Group has yet to complete its restructuring and remains a majority publicly-owned bank, and notes that as a result of its pay policy RBS Group will remain a 'back-marker' in its overall remuneration compared to other banks.

The RBS Group Board acknowledges that this outcome creates a commercial and prudential risk which it must try to mitigate within the framework of a 1:1 fixed to variable compensation ratio.

Business review

Risk factors

Set out below are certain risk factors which could affect RBSH Group's future results and cause them to be materially different from expected results. RBSH Group's results are also affected by competition and other factors. These risk factors, discussed in more detail on pages 186 to 195, should not be regarded as a complete and comprehensive statement of all potential risks and uncertainties.

- RBSH Group is reliant on the RBS Group.

- RBSH Group is subject to a number of legal and regulatory actions and investigations. Unfavourable outcomes in such actions and investigations could have a material adverse effect on RBSH Group's operating results or reputation.

- RBSH Group could fail to attract or retain senior management, which may include members of RBSH Group's Supervisory Board and Managing Board, or other key employees, and it may suffer losses if it does not maintain good employee relations.

- The execution and/or any delay in the execution (or non-completion) of the approved transfers of a substantial part of the business activities of RBS N.V. to RBS plc may have a material adverse effect on RBSH Group.

- Operational risks are inherent in RBSH Group's businesses.

- RBSH Group operates in markets that are highly competitive and its business and results of operations may be adversely affected.

- RBSH Group's businesses and performance can be negatively affected by actual or perceived global economic and financial market conditions.

- RBSH Group has significant exposure to a weakening of the nascent economic recovery in Europe.

- RBSH Group is subject to other global risks.

- RBSH Group's business performance could be adversely affected if its capital is not managed effectively or as a result of changes to capital adequacy and liquidity requirements.

- An extensive restructuring and balance sheet reduction programme of the RBS Group is ongoing and may adversely affect RBSH Group's business, results of operations, financial condition, capital ratios and liquidity.

- RBSH Group's ability to meet its obligations including its funding commitments depends on RBSH Group's ability to access sources of liquidity and funding.

- RBSH Group's borrowing costs, its access to the debt capital markets and its liquidity depend significantly on its credit ratings.

- Each of RBSH Group's businesses is subject to substantial regulation and oversight. Significant regulatory developments and changes in the approach of RBSH Group's key regulators could have a material adverse effect on how RBSH Group conducts its business and on its results of operations and financial condition.

- RBSH Group's operations are highly dependent on its information technology systems.

- RBSH Group's operations have inherent reputational risk.

- RBSH Group may suffer losses due to employee misconduct.

- The financial performance of RBSH Group has been, and continues to be, materially affected by deteriorations in borrower and counterparty credit quality and further deteriorations could arise due to prevailing economic and market conditions and legal and regulatory developments.

- Changes in interest rates, foreign exchange rates, credit spreads, bond, equity and commodity prices, basis, volatility and correlation risks and other market factors have significantly affected and will continue to affect RBSH Group's business and results of operations.

- The value of certain financial instruments recorded at fair value is determined using financial models incorporating assumptions, judgements and estimates that may change over time or may ultimately not turn out to be accurate.

- RBSH Group's earnings and financial condition have been, and its future earnings and financial condition may continue to be, materially affected by depressed asset valuations resulting from poor market conditions.

- The regulatory capital treatment of certain deferred tax assets recognised by RBSH Group depends on there being no adverse changes to regulatory requirements.

- The recoverability of certain deferred tax assets recognised by RBSH Group depends on RBSH Group's ability to generate sufficient future taxable profits and there being no adverse changes to tax legislation or accounting standards.

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

Business review

Key financials			
	2013	2012	2011
for the year ended 31 December	€m	€m	€m
Total income	437	708	4,006
(Loss)/profit before impairment losses	(100)	(822)	1,579
Operating loss before tax	(142)	(887)	(186)

	2013	2012	2011
at 31 December	€m	€m	€m
Total assets	39,808	70,954	146,776
Funded balance sheet (1)	35,026	63,399	127,638
Loans and advances to customers	3,784	6,380	29,578
Deposits	23,094	37,103	86,121
Equity attributable to controlling interests	2,942	1,799	3,395
Capital ratios - Core Tier 1	20.5%	11.7%	8.6%
- Tier 1	23.2%	13.9%	12.0%
- Total	26.1%	19.8%	17.5%

Note:

(1) Funded balance sheet represents total assets less derivatives.

Business review

Summary consolidated income statement			
	2013	2012	2011
	€m	€m	€m
Net interest income	238	605	688
Fees and commissions receivable	119	469	1,039
Fees and commissions payable	(49)	(198)	(367)
Other non-interest income	129	(168)	2,646
Non-interest income	199	103	3,318
Total income	437	708	4,006
Operating expenses	(537)	(1,530)	(2,427)
(Loss)/profit before impairment losses	(100)	(822)	1,579
Impairment losses	(42)	(65)	(1,765)
Operating loss before tax	(142)	(887)	(186)
Tax charge	(12)	(129)	(449)
Loss from continuing operations	(154)	(1,016)	(635)
Profit from discontinued operations, net of tax	19	17	40
Loss for the year attributable to controlling interests	(135)	(999)	(595)

2013 compared with 2012

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

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

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

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

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

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

Tax

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

2012 compared with 2011

Operating loss before tax was €887 million compared with a loss of €186 million in 2011. This decrease was due to lower total income partially offset by lower operating expenses and lower impairment losses.

Total income decreased by €3,298 million to €708 million. This is mainly due to a lower own credit adjustment in non-interest income.

Net interest income decreased by €83 million to €605 million, reflecting further reductions in interest income, in particular in International Banking, mainly due to business transfers to RBS plc.

Non-interest income decreased by €3,215 million to €103 million compared with €3,318 million in 2011. This decrease is mainly due to the €2,155 million lower own credit adjustment resulting from to the tightening of credit spreads. In addition, fee and trading income were lower as a result of business transfers to RBS plc.

Operating expenses decreased by €897 million to €1,530 million due to reduced activities as a result of business transfers to RBS plc.

Impairment losses decreased by €1,700 million to €65 million this decrease mainly relates to Greek sovereign available-for-sale bond impairments and related interest rate hedge adjustments, which decreased by €1,428 million from €1,463 million.

Tax

The tax charge for 2012 was €129 million compared with €449 million in 2011. The higher charge for 2011 was mainly the result of losses on Greek sovereign available-for-sale bonds being not recoverable for tax purposes.

Analysis of results			
Net interest income			
	2013	2012	2011
	€m	€m	€m
Interest receivable	768	1,628	2,352
Interest payable (1)	(493)	(1,023)	(1,664)
Net interest income	275	605	688
Yields, spreads and margins of the banking business	%	%	%
Gross yield on interest-earning assets of the banking business (2)	1.8	2.1	2.1
Cost of interest-bearing liabilities of the banking business	(1.3)	(1.4)	(1.5)
Interest spread of the banking business (3)	0.5	0.7	0.6
Benefit from interest-free funds	0.2	0.1	—
Net interest margin of the banking business (4)	0.7	0.8	0.6
Gross yield (2)			
- Group	1.8	2.1	2.1
- Domestic	1.1	1.4	1.8
- Foreign	3.2	2.8	2.4
Interest spread (3)			
- Group	0.5	0.7	0.6
- Domestic	0.4	(0.1)	(0.1)
- Foreign	1.0	1.6	1.2
Net interest margin (4)			
- Group	0.7	0.8	0.6
- Domestic	0.5	(0.2)	(0.1)
- Foreign	1.0	1.8	1.2

Notes:

(1) Interest payable has been decreased by €37 million (2012 and 2011 - nil) in respect of non-recurring adjustments.

(2) Gross yield is the interest rate earned on average interest-earning assets of the banking business.

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(3) Interest spread is the difference between the gross yield and the interest rate paid on average interest-bearing liabilities of the banking business.

(4) Net interest margin is net interest income of the banking business as a percentage of average interest-earning assets of the banking business.

(5) The analysis into Domestic and Foreign has been compiled on the basis of location of the entity in which the transaction takes place.

Business review

Average balance sheet and related interest							
		2013			2012		
		Average balance	Interest	Rate	Average balance	Interest	Rate
		€m	€m	%	€m	€m	%
Assets							
Loans and advances to banks	- Domestic	6,130	51	0.8	7,779	59	0.8
	- Foreign	5,755	49	0.9	15,615	148	0.9
Loans and advances to customers	- Domestic	1,002	32	3.2	6,691	154	2.3
	- Foreign	6,386	307	4.8	16,677	711	4.3
Amounts due from ultimate holding company	- Domestic	2,805	183	6.5	2,091	114	5.5
Debt securities	- Domestic	18,014	53	0.3	24,274	272	1.1
	- Foreign	1,876	93	5.0	4,086	170	4.2
Interest-earning assets	- banking business	41,968	768	1.8	77,213	1,628	2.1
	- trading business	2,021			5,623		
Interest-earning assets		43,989			82,836		
Non-interest-earning assets		17,493			32,904		
Total assets		61,482			115,740		
Percentage of assets applicable to overseas operations		41.0%			50.5%		
Liabilities							
Deposits by banks	- Domestic	20,711	117	0.6	26,210	283	1.1
	- Foreign	7,064	71	1.0	15,613	129	0.8
Customer accounts: demand deposits	- Domestic	—	—	—	7,090	60	0.8
	- Foreign	2,733	11	0.4	12,900	66	0.5
Customer accounts: savings deposits	- Foreign	554	21	3.8	768	28	3.6
Customer accounts: other time deposits	- Domestic	547	16	2.9	1,372	44	3.2
	- Foreign	1,950	82	4.2	3,767	140	3.7

Debt securities in issue	- Domestic	115	4	3.5		4,258	63	1.5
	- Foreign	641	13	2.0		1,038	22	2.1
Subordinated liabilities	- Domestic	3,488	41	1.2		4,375	70	1.6
	- Foreign	2,089	125	6.0		2,776	162	5.8
Internal funding of trading business	- Foreign	(779)	(8)	1.0		(4,429)	(44)	1.0
Interest-bearing liabilities	- banking business (1)	39,113	493	1.3		75,738	1,023	1.4
	- trading business	2,694				11,934		
Interest-bearing liabilities		41,807				87,672		
Non-interest-bearing liabilities:								
Demand deposits	- Domestic	311				706		
	- Foreign	861				2,084		
Other liabilities		11,775				21,466		
Owners' equity		6,728				3,812		
Total liabilities and owners' equity		61,482				115,740		
Percentage of liabilities applicable to overseas operations		40.1%				54.9%		

For notes to this table refer to page 13.

Business review

Average balance sheet and related interest continued				
		2011		
		Average balance	Interest	Rate
		€m	€m	%
Assets				
Loans and advances to banks	- Domestic	4,707	126	2.7
	- Foreign	25,521	207	0.8
Loans and advances to customers	- Domestic	9,234	193	2.1
	- Foreign	28,463	1,058	3.7
Amounts due from ultimate holding company	- Domestic	238	13	5.5
Debt securities	- Domestic	34,764	560	1.6
	- Foreign	6,610	195	3.0
Interest-earning assets	- banking business	109,537	2,352	2.1
	- trading business	19,958		
Interest-earning assets		129,495		
Non-interest-earning assets		62,071		
Total assets		191,566		
Percentage of assets applicable to overseas operations		67.5%		
Liabilities				
Deposits by banks	- Domestic	23,503	440	1.9
	- Foreign	30,657	125	0.4
Customer accounts: demand deposits	- Domestic	9,853	217	2.2
	- Foreign	21,378	270	1.3
Customer accounts: savings deposits	- Domestic	209	—	—
	- Foreign	197	5	2.5
Customer accounts: other time deposits	- Domestic	3,394	64	1.9
	- Foreign	5,796	175	3.0
Debt securities in issue	- Domestic	9,613	146	1.5
	- Foreign	3,049	53	1.7

Subordinated liabilities	- Domestic	3,335	79	2.4
	- Foreign	3,281	151	4.6
Internal funding of trading business	- Foreign	(3,424)	(61)	1.8
Interest-bearing liabilities	- banking business (1)	110,841	1,664	1.5
	- trading business	34,431		
Interest-bearing liabilities		145,272		
Non-interest-bearing liabilities:				
Demand deposits	- Foreign	4,503		
Other liabilities		37,266		
Owners' equity		4,525		
Total liabilities and owners' equity		191,566		
Percentage of liabilities applicable to overseas operations		68.8%		

For notes to this table refer to page 13.

Business review

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

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

	2013 over 2012				2012 over 2011		
	Increase/(decrease) due to changes in:				Increase/(decrease) due to changes in:		
	Average volume	Average rate	Net change		Average volume	Average rate	Net change
	€m	€m	€m		€m	€m	€m
Interest-earning assets							
Loans and advances to banks							
Domestic	(13)	5	(8)		54	(121)	(67)
Foreign	(85)	(14)	(99)		(90)	31	(59)
Loans and advances to customers							
Domestic	(166)	44	(122)		(57)	18	(39)
Foreign	(485)	81	(404)		(486)	139	(347)
Amounts due from ultimate holding company							
Domestic	44	25	69		101	—	101
Debt securities							
Domestic	(57)	(162)	(219)		(143)	(145)	(288)
Foreign	(105)	28	(77)		(89)	64	(25)
Total interest receivable of the banking business							
Domestic	(192)	(88)	(280)		(45)	(248)	(293)
Foreign	(675)	95	(580)		(665)	234	(431)
	(867)	7	(860)		(710)	(14)	(724)
Interest-bearing liabilities							
Deposits by banks							
Domestic	51	115	166		(46)	203	157
Foreign	82	(24)	58		82	(86)	(4)
Customer accounts: demand deposits							
Domestic	30	30	60		49	108	157
Foreign	43	12	55		82	122	204
Customer accounts: savings deposits							

Foreign	8	(1)	7		(20)	(3)	(23)
Customer accounts: other time deposits							
Domestic	24	4	28		50	(30)	20
Foreign	75	(17)	58		70	(35)	35
Debt securities in issue							
Domestic	96	(37)	59		79	4	83
Foreign	8	1	9		41	(10)	31
Subordinated liabilities							
Domestic	13	16	29		(21)	30	9
Foreign	41	(4)	37		26	(37)	(11)
Internal funding of trading business							
Foreign	(37)	1	(36)		15	(32)	(17)
Total interest payable of the banking business							
Domestic	214	128	342		111	315	426
Foreign	220	(32)	188		296	(81)	215
	434	96	530		407	234	641
Movement in net interest income							
Domestic	22	40	62		66	67	133
Foreign	(455)	63	(392)		(369)	153	(216)
	(433)	103	(330)		(303)	220	(83)

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Divisional performance

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

	2013	2012	2011
Operating profit/(loss) before tax	€m	€m	€m
Markets	23	(503)	1,342
International Banking	(18)	182	81
Central items	(359)	(535)	(1,270)
Core	(354)	(856)	153
Non-Core	212	(31)	(339)
	(142)	(887)	(186)

Employee numbers at 31 December			
(full time equivalents rounded to the nearest hundred)			
	2013	2012	2011
Markets	700	2,900	6,300
International Banking	1,100	5,500	6,600
Central items	100	300	600
Core	1,900	8,700	13,500
Non-Core	600	2,600	4,200
	2,500	11,300	17,700

Business review

Divisional performance continued			
Markets			
	2013	2012	2011
	€m	€m	€m
Net interest income	35	142	66
Non-interest income	239	70	2,589
Total income	274	212	2,655
Direct expenses			
- staff costs	(26)	(363)	(696)
- other	(133)	(318)	(511)
Indirect expenses	(34)	1	(53)
Total expenses	(193)	(680)	(1,260)
Profit/(loss) before impairment losses	81	(468)	1,395
Impairment losses	(58)	(35)	(53)
Operating profit/(loss) before tax	23	(503)	1,342
	€bn	€bn	€bn
Balance sheet			
Third party assets	15	30	72
Third party liabilities	15	36	77

2013 compared with 2012

Operating profit before tax was €23 million compared with a loss of €503 million in 2012. This improvement of €526 million was mainly due to lower operating expenses.

Total income increased by €62 million to €274 million mainly attributable to an increase in non-interest income.

Net interest income decreased by €107 million to €35 million compared with €142 million in 2012. This reflects the transfer of businesses to RBS plc.

Non-interest income increased by €169 million to €239 million in 2013 compared with €70 million in 2012, primarily due to lower losses in other operating income. This was offset by lower fee and trading income as a result of the transfer of businesses to RBS plc.

Total expenses decreased by €487 million to €193 million compared with €680 million in 2012. This reflects the continuing transfer of businesses to RBS plc.

Impairment losses increased by €23 million to €58 million compared with €35 million in 2012. The impairments in 2013 and 2012 reflect a small number of single name provisions.

2012 compared with 2011

Operating loss before tax was €503 million compared with a profit of €1,342 million in 2011. This decrease of €1,845 million was mainly due to lower total income partly offset by lower operating expenses.

Total income decreased by €2,443 million to €212 million mainly due to the decrease in non-interest income.

Net interest income increased by €76 million to €142 million compared with €66 million in 2011. This reflects lower funding costs after the transfer of businesses to RBS plc.

Non-interest income decreased by €2,519 million to €70 million in 2012 compared with €2,589 million in 2011, primarily due a €1,602 million decrease in other operating income. This is mainly due to the €1,390 million lower own credit adjustment attributable to the tightening of credit spreads. The remaining decrease in other operating income is largely due to a lower gain on the currency translation reserve release related to the transfer of businesses to RBS plc of €167 million compared with €404 million in 2011. In addition, fee and trading income were €893 million lower as a result of the transfer of businesses to RBS plc.

Total expenses decreased by €580 million to €680 million compared with €1,260 million in 2011. This reflects the continuing transfer of businesses to RBS plc.

Impairment losses decreased by €18 million to €35 million compared with €53 million in 2011. Impairments in both 2012 and 2011 reflect a small number of single name provisions.

Tax

Business review

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Divisional performance continued			
International Banking			
	2013	2012	2011
	€m	€m	€m
Net interest income	77	280	490
Non-interest income	87	444	548
Total income	164	724	1,038
Direct expenses			
- staff costs	(44)	(239)	(323)
- other	(47)	(339)	(455)
Indirect expenses	(97)	12	33
Total expenses	(188)	(566)	(745)
(Loss)/profit before impairment losses	(24)	158	293
Impairment recoveries/(losses)	6	24	(212)
Operating (loss)/profit before tax	(18)	182	81
	€bn	€bn	€bn
Balance sheet			
Third party assets	2	4	24
Third party liabilities	2	7	35

2013 compared with 2012

Operating loss before tax was €18 million compared with a profit of €182 million in 2012. This decrease of €200 million was mainly due to lower total income partially offset by lower operating expenses.

Total income decreased by €560 million to €164 million due to decreases in both net interest income and non-interest income.

Net interest income decreased by €203 million to €77 million compared with €280 million in 2012. This reflects further reductions in lending mainly due to the transfer of businesses to RBS plc.

Non-interest income decreased by €357 million to €87 million compared with €444 million in 2012. This is mainly due to the transfer of businesses to RBS plc.

Total expenses decreased by €378 million to €188 million compared with €566 million in 2012 as a result of the transfer of businesses to RBS plc.

Impairment recoveries decreased by €18 million to €6 million compared with €24 million in 2012.

2012 compared with 2011

Operating profit before tax was €182 million compared with €81 million in 2011. This increase of €101 million was mainly due to lower operating expense and higher impairment recoveries partly offset by lower total income.

Total income decreased by €314 million to €724 million due to decreases in both net interest income and non-interest income.

Net interest income decreased by €210 million to €280 million compared with €490 million in 2011. This reflects further reductions in lending mainly due to the transfer of businesses to RBS plc.

Non-interest income decreased by €104 million to €444 million compared with €548 million in 2011. This is mainly due to the transfer of businesses to RBS plc.

Total expenses decreased by €179 million to €566 million compared with €745 million in 2011 as a result of the transfer of businesses to RBS plc.

Impairments improved by €236 million to a recovery of €24 million compared with a loss of €212 million in 2011. The impairments in 2011 were largely driven by a single name provision.

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Business review

Divisional performance continued			
Central items			
	2013	2012	2011
	€m	€m	€m
Net interest income	(12)	(34)	(110)
Non-interest income	(233)	(396)	407
Total income	(245)	(430)	297
Direct expenses			
- staff costs	(74)	(62)	(69)
- other	(145)	(17)	(49)
Indirect expenses	151	(3)	14
Total expenses	(68)	(82)	(104)
(Loss)/profit before impairment losses	(313)	(512)	193
Impairment losses	(46)	(23)	(1,463)
Operating loss before tax	(359)	(535)	(1,270)
	€bn	€bn	€bn
Balance sheet			
Third party assets	16	29	39
Third party liabilities	14	20	25

2013 compared with 2012

Operating loss before tax was €359 million compared with a loss of €535 million in 2012. The reduced loss is largely due to lower total income losses.

Total income losses improved by €185 million to a loss of €245 million, mainly reflecting lower non-interest income losses.

Net interest income improved by €22 million to a loss of €12 million. This mainly reflects the lower funding costs as a result of third party funding being replaced by funding from RBS plc as part of the transfer of businesses to RBS plc.

Tax

Non-interest income losses decreased by €163 million to a loss of €233 million compared with a loss of €396 million in 2012. This is mainly due to lower own credit adjustment attributable to the tightening of credit spreads.

Total expenses decreased by €14 million to €68 million compared with €82 million in 2012.

Impairment losses increased by €23 million to €46 million compared with €23 million in 2012.

2012 compared with 2011

Operating loss before tax was €535 million compared with a loss of €1,270 million in 2011. The reduced loss is largely due to lower impairment losses partly offset by lower total income.

Total income decreased by €727 million to a loss of €430 million, mainly reflecting lower non-interest income.

Net interest income increased by €76 million to a loss of €34 million. This mainly reflects the lower funding costs as a result of third party funding being replaced by funding from RBS plc as part of the transfer of businesses to RBS plc.

Non-interest income decreased by €803 million to a loss of €396 million compared with a gain of €407 million in 2011 primarily due to the decrease in other operating income. This is mainly due to the €765 million lower own credit adjustment attributable to the tightening of credit spreads.

Total expenses decreased by €22 million to €82 million compared with €104 million in 2011 due to a litigation recovery.

Impairment losses decreased by €1,440 million to €23 million compared with €1,463 million in 2011. This decrease mainly relates to Greek sovereign available-for-sale bonds impairment and related interest rate hedge adjustments, which decreased by €1,428 million, from €1,463 million in 2011 to €35 million in 2012.

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Business review

Divisional performance continued			
Non-Core			
	2013	2012	2011
	€m	€m	€m
Net interest income	138	217	242
Non-interest income	106	(15)	(226)
Total income	244	202	16
Direct expenses			
- staff costs	(31)	(77)	(122)
- other	(38)	(115)	(197)
Indirect expenses	(19)	(10)	1
Total expenses	(88)	(202)	(318)
Profit/(loss) before impairment losses	156	—	(302)
Impairment losses	56	(31)	(37)
Operating profit/(loss) before tax	212	(31)	(339)
	€bn	€bn	€bn
Balance sheet			
Third party assets	7	8	12
Third party liabilities	6	5	7

2013 compared with 2012

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

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

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

Tax

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

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

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

2012 compared with 2011

Operating loss before tax was €31 million compared with a loss of €339 million in 2011, largely due to higher total income and lower expenses.

Total income increased by €186 million to €202 million mainly due to a lower loss in non-interest income.

Net interest income decreased by €25 million to €217 million compared with €242 million in 201,1 following continuing disposals.

Non-interest income improved by €211 million to a loss of €15 million compared with a loss of €226 million in 2011. The increase is mainly due to lower losses on sale and revaluation of assets compared with 2011.

Total expenses decreased by €116 million to €202 million compared with €318 million in 2011. The decrease reflects continuing disposals.

Impairment losses decreased by €6 million to €31 million compared with €37 million in 2011.

Business review

Consolidated balance sheet at 31 December 2013			
	2013	2012	2011
	€m	€m	€m
Assets			
Cash and balances at central banks	3,193	2,294	12,609
Net loans and advances to banks	5,642	12,138	16,817
Reverse repurchase agreements and stock borrowing	53	68	9,100
Loans and advances to banks	5,695	12,206	25,917
Net loans and advances to customers	3,782	6,375	29,295
Reverse repurchase agreements and stock borrowing	2	5	283
Loans and advances to customers	3,784	6,380	29,578
Amounts due from ultimate holding company	2,820	2,949	1,136
Debt securities	15,288	22,655	39,645
Equity shares	295	1,127	3,093
Settlement balances	10	31	2,608
Derivatives	4,782	7,555	19,138
Deferred tax	40	420	444
Prepayments, accrued income and other assets	1,853	1,533	5,913
Assets of disposal groups	2,048	13,804	6,695
Total assets	39,808	70,954	146,776
Liabilities			
Bank deposits	7,233	21,841	29,988
Repurchase agreements and stock lending	11,710	12,624	16,532
Deposits by banks	18,943	34,465	46,520
Customers deposits	4,118	2,620	38,842
Repurchase agreements and stock lending	33	18	759
Customer accounts	4,151	2,638	39,601
Debt securities in issue	1,319	2,602	17,714
Settlement balances and short positions	105	107	3,409
Derivatives	5,862	9,644	19,868
Accruals, deferred income and other liabilities	1,065	1,782	3,895
Deferred tax	63	40	201
Subordinated liabilities	4,951	6,851	6,859
Liabilities of disposal groups	407	11,026	5,293
Total liabilities	36,866	69,155	143,360

Non-controlling interests	—	—	21
Controlling interests	2,942	1,799	3,395
Total equity	2,942	1,799	3,416
Total liabilities and equity	39,808	70,954	146,776

Commentary on consolidated balance sheet

2013 compared with 2012

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

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

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

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

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

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

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

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

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

Customer accounts were up €1.5 billion, 57%, to €4.1 billion.

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

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

Business review

2012 compared with 2011

Total assets were €71.0 billion at 31 December 2012, a decrease of €75.8 billion, or 52%, compared with €146.8 billion at 31 December 2011.

Cash and balances at central banks decreased by €10.3 billion or 82% to €2.3 billion due to reduced liquidity requirements following the transfer of businesses to RBS plc during the year, in particular the Dutch Scheme. In addition the decrease is due to the 2013 Transfers being classified as assets of disposal groups (€3.5 billion).

Loans and advances to banks decreased by €13.7 billion, or 53%, to €12.2 billion principally due the transfer of businesses to RBS plc during the year, in particular the Dutch Scheme. In addition the decrease is due to the 2013 Transfers being classified as assets of disposal groups (€1.2 billion) and a decline in bank placings.

Loans and advances to customers declined €23.2 billion, or 78%, to €6.4 billion. This reflected the transfer of businesses to RBS plc during the year, in particular the International Banking businesses included within the Dutch Scheme. In addition the decrease is due to the 2013 Transfers being classified as assets of disposal groups (€2.3 billion).

Debt securities decreased by €17.0 billion to €22.7 billion, reflecting a reduction in holdings of eurozone government and financial institution bonds (€9.8 billion), the transfer of businesses to RBS plc as part of the Dutch Scheme and the 2013 Transfers being classified as assets of disposal groups (€2.7 billion).

Equity shares decreased by €2.0 billion to €1.1 billion. This reflected the transfer of businesses to RBS plc as part of the Dutch Scheme.

Derivative assets decreased by €11.6 billion, or 61%, to €7.6 billion, and Derivative liabilities decreased by €10.2 billion, or 52%, to €9.6 billion this was largely attributable to the transfer of businesses to RBS plc as part of the Dutch Scheme.

The increase in assets and liabilities of disposal groups is due to the inclusion of the 2013 Transfers. These businesses are part of the Transfers for 2013 that meet the IFRS 5 definition of being held for disposal as at 31 December 2012.

Deposits by banks decreased by €12.1 billion, or 26%, to €34.5 billion, with lower repurchase agreements and stock lending (repos), down €3.9 billion, 24%, to €12.6 billion. This reduction is mainly due to the transfer of businesses to RBS plc during the year, in particular the Dutch Scheme. In addition the decrease is due to the downsizing of the fiduciary business in Markets and planned reductions in funding from RBS plc. This was partially offset by an increase in funding provided by the European Central Bank's Long Term Refinancing Operation (LTRO).

Customer accounts were down €37.0 billion, or 93%, to €2.6 billion, mainly due to the transfer of businesses to RBS plc during the year, in particular the Dutch Scheme.

Debt securities in issue declined €15.1 billion, or 85%, to €2.6 billion, largely as a result of the transfer of businesses to RBS plc during the year, in particular the Dutch Scheme and a decrease in notes and commercial paper outstanding reflecting positions maturing in Markets and Group Treasury.

Owners equity decreased by €1.6 billion, or 47%, to €1.8 billion, largely driven by the Dutch Scheme.

***Business review** Risk and balance sheet management*

***Business review** Risk and balance sheet management*

Introduction

Risk and balance sheet management are conducted on an overall basis within RBS Group. Therefore the discussion on risk and balance sheet management on pages 25 to 77 refers principally to policies and procedures in RBS Group that also apply to RBSH Group.

Risk governance*

Governance structure

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

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

The management of risk in RBS Group is carried out through two independent risk management functions - RBS Risk Management and Group Conduct and Regulatory Affairs - which manage risk through independent oversight and challenge of the customer-facing businesses and support functions. The functions provide an overarching risk control framework.

A number of key committees specifically consider risk across RBS Group including RBSH Group.

RBS Group Board - Sets and owns RBS Group's risk appetite, which is cascaded across its divisions, functions and material legal entities. It also sets RBS Group's strategic direction and carries out regular assessments to ensure that strategic plans are consistent with risk appetite.

RBS Board Risk Committee - Provides oversight and advice on current and potential risk exposures, risk strategy and tolerance. The Committee also promotes a risk awareness culture within RBS Group.

RBS Group Executive Committee - Operates under delegated authority from Group Board and considers emerging issues material to both the Group's strategy and risk exposures. The Group Executive Committee also oversees control frameworks.

RBS Executive Risk Forum - Provides executive input to the Group Board and the Group Executive Committee on risk management issues such as risk appetite, risk policies and risk management strategies.

It has full authority to act on all material and/or enterprise-wide risk and control matters across the Group and implements Group Board and Group Executive Committee risk management decisions.

Risk management

The RBS Group Chief Risk Officer leads the RBS Risk Management function through the strategic setting and execution of its responsibilities reports to the RBS Group Chief Executive and the RBS Group Board Risk Committee. The Group Chief Risk Officer also has a right of access to the RBSG Chairman.

RBS Risk Management is designed to align as closely as possible with the customer-facing businesses and support functions while maintaining an appropriate level of independence, which underpins RBS Group's approach to risk management and is reinforced through RBS Group by appropriate reporting lines from divisions to RBS Risk Management and from RBS Risk Management to senior executives, boards and committees.

In RBS Risk Management, the following RBS Group functional heads report directly to the RBS Group Chief Risk Officer and are responsible for firm-wide risk appetite and standards under their respective disciplines:

- RBS Group Head of Operational Risk;
- RBS Group Chief Credit Officer;
- Head of Enterprise Risk Management;
- Head of Global Country Risk; and
- Chief Operating Officer, RBS Risk Management;

The RBSH Group Chief Risk Officer also has a reporting line into the RBS Group Chief Risk Officer.

Risk management within RBSH Group focuses on all material risks including credit, market, operational, regulatory and country risk and business activities. Liquidity risk and the day-to-day management of liquidity and funding of the book are the responsibility of RBSH Group Treasury (refer to page 38).

For a summary of the main risk types faced by RBSH Group and how it manages each of them, refer to pages 30 to 32.

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The following table shows details of the key Boards and Committees and their responsibilities.

Board/Committee	Responsibilities
Supervisory Board Membership Consists of five members. Three are executives of RBS Group.	The Supervisory Board is responsible for supervising RBSH Group's management and RBSH Group's general affairs and the business connected with it and for advising the Managing Board.
Managing Board Membership RBSH Group Chairman, RBSH Group Chief Administrative Officer (CAO), RBSH Group Chief Financial Officer (CFO) and RBSH Group Chief Risk Officer (CRO).	The Managing Board reports to the Supervisory Board and is the principal decision-making forum for RBSH Group. It sets the policy framework, the operating structure and the yearly plan, including objectives and budgets. All members of the Managing Board have responsibility for RBSH Group. As well as their overall corporate responsibilities, the members of the Managing Board each manage one or more units, for which they have primary responsibility.
RBSH Group Risk and Control Committee (RCC) Membership Chaired by the RBSH Group CRO. Members include RBSH Group CFO, RBS NV Head of Risk Office/Senior NV Risk Manager, NV delegates of RBS Group Credit, Market, and Operational Risk, RBS NV Head of Conduct & Regulatory Affairs, CROs for RBS NV Asia Pacific and Americas.	The responsibilities of the RCC include: • Advising the Managing Board on the risk appetite of RBSH Group. They receive direction from the Managing Board on risk appetite; • Providing input to the RBSH Group risk-appetite-setting process in the context of the Group's overall risk appetite; • Overseeing the risk framework within RBSH Group and reporting directly to the RBSH Group Managing Board on the performance of the framework and on issues arising from it; • Monitoring the actual risk profile of RBSH Group and ensure that this remains within the boundaries of the

agreed risk appetite or escalate excesses to the RBSH Group Managing Board. Prior to escalation, the RCC can ask the appropriate risk committee in RBS Group or in the division that in the normal course of business monitors and controls the risk item that is in excess to address the excess; and

- The remit of the Committee includes credit, market, operational and regulatory risk within RBS N.V. Any changes to the terms of reference of the RBSH Group RCC must be approved by the RBSH Group Managing Board. To execute its authority, the RCC has access to all relevant risk information relating to RBSH Group available within RBS Group including escalations from and to Group or divisional committees.

RBSH Group Asset and Liability Committee (ALCO)

The mandate of ALCO covers the following specific areas in respect of RBSH Group:

- The overall governance responsibility for the strategic management of the RBSH Group balance sheet;
- The review, approval and allocation of balance sheet, capital, liquidity and funding limits;
- The liquidity, funding, foreign exchange and interest rate exposures of RBSH Group's balance sheet;
- The balance sheet structure and RWA position of RBSH Group;
- Decisions on capital repatriation and loss coverage;
- Compliance with all regulatory requirements at all times;
- The implementation and maintenance of transfer pricing policies (although setting the liquidity spread curve remains the responsibility of the RBS Group ALCO);
- The approval and implementation within RBSH Group of RBS Group Treasury policies and procedures; and
- Oversight of retained business (shared assets) and residual ABN AMRO business.

Membership

Nine permanent voting members led by the RBSH Group Chairman of the Managing Board. The other Committee members are: RBSH Group CFO; RBSH Group CAO; RBSH Group CRO; RBS NV Treasurer; EMEA Treasurer; Markets Treasurer; International Banking Treasurer; and the Global Head of Equity and Liquidity Management.

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Conduct and Regulatory Affairs

Created in August 2013, by combining RBS Group Compliance (previously part of RBS Risk Management) and RBS Regulatory Affairs (formerly part of RBS Legal), RBS Group Conduct and Regulatory Affairs is led by the RBS Group Head of Conduct and Regulatory Affairs, who reports directly to the RBS Group Chief Executive and the RBS Board Risk Committee.

Three lines of defence

A strong three lines of defence model is an important element of a robust control environment. The model's main purpose is to define accountabilities and responsibilities for managing risk across RBS Group.

1st line of defence - Business units including all business areas and functions are accountable for owning and managing the risks which exist in their business area within a defined risk appetite and framework.

2nd line of defence - Independent monitoring and control functions, as well as RBS Group policy standard owners, are accountable for owning and developing the risk and control frameworks and tools which the 1st line of defence uses to discharge its responsibilities. The 2nd line of defence must be appropriately independent from the business and accountable for overseeing and challenging the 1st line of defence on the effective management of its risks.

3rd line of defence - RBSH Group Internal Audit provides independent assurance on the appropriateness of the design and operational effectiveness of risk management and internal control processes that

mitigate RBSH Group's key risks.

Risk appetite*

RBSH Group's risk appetite identifies and establishes the level and type of risks that it is able and willing to take in executing its chosen business strategy, to protect itself against events that may have an adverse impact on its profitability or its capital base. RBSH Group has developed a framework that sets and implements an appropriate risk appetite supported by a regular monitoring and review process. A risk appetite statement setting out overall risk limits for different risk types is approved by the Supervisory Board. Risk appetite limits and risk exposures are reported monthly to the RCC, the Managing Board and the Supervisory Board. Any limit breach is reported to the Managing Board. The Managing Board may grant a temporary waiver or require the position to be adjusted to comply with the risk limit. For limits other than risk appetite limits authority has been delegated to the RCC, ALCO and, for certain market risk limits, the Head of Market Risk. The RBS NV RCC and ALCO each have three or more Managing Board members.

Strategic risk objectives

Risk management plays an integral role in the delivery of the RBS Group's strategic goal to be a safe and secure banking group. The implementation of a stronger and more effective culture of risk management and control provides the platform necessary to address historical vulnerabilities, rebuild upon the RBS Group's core strengths and position it on a sustainable and profitable path for future growth.

In 2009 the RBS Group Board set out four key strategic objectives, aligned with RBS Group's Strategic Plan. These are to:

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

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

This is how we bring our Strategic Plan to life in our management of risk.

Risk appetite measures

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

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

- *Economic capital -* provides complementary insights, with a breadth of understanding of risk profile changes and 'tail risks' generated by simulating millions of different scenarios.

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

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Risk control frameworks and limits

Risk control frameworks and their associated limits are an integral part of the risk appetite framework and a key part of embedding risk appetite targets in day-to-day risk management.

Risk appetite has its own policy standard within the RBS Group Policy Framework that sets out clear roles and responsibilities to measure, cascade and report performance against risk appetite, as well as to provide assurances that business is being conducted within approved risk limits and tolerances.

Culture, values and remuneration

Objectives for risk culture

Risk culture plays a key role in the RBS Group's ambition to build 'a really good bank'. A strong risk culture is a key part of ensuring risk appetite is effectively embedded across the RBS Group.

Risk culture policies

The RBS Group values - 'serving customers well', 'working together', 'doing the right thing' and 'thinking long term' - act as a clear starting point for a strong and effective risk culture. A wide range of communication and engagement activities (detailed below) has been undertaken to discuss the meaning of each value with employees and how they impact upon and guide day-to-day activities.

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

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

Training

Across the risk management function, a series of events and activities have been undertaken to ‘bring alive’ the Group’s values and culture for employees. This is supported by performance management processes that hold individuals to account for poor behaviour and that the behaviour that supports our purpose, visions and values is rewarded.

Challenge mechanisms

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

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

Each question contains a little prompt to think about the situation and how it fits with the values. It ensures that employees can think through decisions that don’t have a clear answer, guiding the way they think and the judgements behind their decisions and actions.

Risk-based key performance indicators

Our policy standards require all current Code Staff roles to use a balanced scorecard approach to performance management. This ensures a balance between financial and non-financial metrics, including an evaluation of adherence to internal controls and risk management. Since 2011, there has been an enhanced requirement for all Code Staff roles to have specific risk objectives within their performance plan.

Unvested awards are subject to clawback and may be reduced, or forfeited in full, at the discretion of the RBS Group Performance and Remuneration Committee.

Awards to employees under the RBS Group's long term incentive plan are subject to financial and operational measures and an underlying requirement for effective risk management during the performance period.

The Group Performance and Remuneration Committee has put in place a RBS Group-wide remuneration policy which is explicitly aligned to effective risk management. Performance is a key input into the determining of remuneration levels

Risk coverage

We continued to strengthen our approach to risk management amid a challenging and ever-changing external environment. Areas of progress included:

- The completion of the phased roll-out of the RBS Group's conduct risk policies and of a more effective operating model, supported by the development and delivery of awareness initiatives and targeted training;
- The introduction of a new integrated operating model for managing regulatory developments, which combines divisional and functional teams to leverage expertise more effectively; and
- Further strengthening our credit risk and country risk appetite and management frameworks.

Business review *Risk and balance sheet management*

The main risk types faced by the RBSH Group are presented below, together with a summary of the key areas of focus and how the RBSH Group managed these risks in 2013.

Risk type	Definition	Features	How RBSH Group manages risk and the focus in 2013
Capital adequacy risk	The risk that the RBSH Group has insufficient capital.	Arises from: Inefficient management of capital resources. Character and impact: Characterised typically by credit risk losses. It has the potential to disrupt the business model and stop normal business activities. It also has the potential to cause the RBSH Group to fail to meet regulatory requirements.	The RBSH Group's Core Tier 1 ratio on a Basel 2.5 basis was 20.5%. RBSH Group plans for and maintains an adequate amount and mix of capital consistent with its risk profile. The amount of capital required is determined through risk assessments and stress testing. Refer to pages 33 to 36.
Liquidity and funding risk	The risk that the RBSH Group is unable to meet its financial liabilities as they fall due.	Arises from: RBSH Group's day-to-day operations. Character and impact: Dependent on company-specific factors such as maturity profile and composition of sources and uses of funding, the quality and size of liquid asset buffer as well as broader market factors.	Refer to pages 37 to 39.

Risk appetite measures

		It can result in RBSH Group failing to meet regulatory liquidity requirements, unable to support normal banking activity or at worst ceasing to be a going concern. Adverse impact on customer and investor confidence in the RBSH Group and the wider financial system is also possible.	
Credit risk	The risk that the RBSH Group will incur losses owing to the failure of a customer or counterparty to meet its obligation to settle outstanding amounts.	Arises from: Deterioration of the credit quality of Counterparties or customers of the RBSH Group, leaving them unable to meet their contractual obligations.	RBSH Group manages credit risk based on a suite of credit approval and risk concentration frameworks and associated risk management systems and tools. Refer to pages 40 to 46.
		Character and impact: Losses can vary materially across portfolios and may include concentration risk - the risk of loss due to the concentration of credit risk related to a specific product, asset class, sector or counterparty. It has the potential to affect adversely the RBSH Group's financial performance and capital.	

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Risk type	Definition	Features	How the RBSH Group manages risk and the focus in 2013
Country risk	The risk of material losses arising from significant country-specific events.	Arises from: Sovereign events, economic events, political events, natural disasters or conflicts. Potential to affect parts of the RBSH Group's credit portfolio that are directly or indirectly linked to the country in question.	RBS Group Country Risk manages country risk matters including risk appetite; risk management strategy and framework; risk exposure and policy; sovereign ratings; sovereign loss-given-default rates; and country Watchlist colours, with escalation where needed to the Managing Board and where appropriate to the Supervisory Board. Regular, detailed reviews are carried out on all portfolios to ensure they remain in line with the country risk appetite and reflect evolving economic and political developments. A country risk Watchlist process identifies emerging issues and assists in the development of mitigation strategies. In 2013, the scope of this process was widened to include all countries with RBS Group exposure. Balance sheet exposure to the eurozone periphery countries continued to fall, and was down by 21% to €6.9 billion at the end of 2013. Refer to pages 57 to 62.
Market risk			

	The risk arising from fluctuations in interest rates, foreign currency, credit spreads, equity prices, commodity prices and risk-related factors such as market volatilities that may lead to a reduction in earnings, economic value or both.	Arises from: Adverse movements in market prices. Character and impact: Characterised by frequent small losses, which are material in aggregate, and infrequent large material losses due to stress events. It has the potential to materially affect Group Treasury where RBSH Group has important exposures. RBSH Group's non-trading activities in retail and commercial businesses can also be affected through interest rate risk and foreign exchange non traded exposures.	During 2013, RBSH Group continued to reduce its risk exposures. Average trading value-at-risk (VaR) decreased from €4.4 million to €2.0 million, reflecting risk reduction and capital management focus. Refer to pages 63 to 71.
Pension risk	The risk to a firm caused by its contractual or other liabilities to, or with respect to, its pension schemes, whether established for its employees or for those of a related company or otherwise.	Arises from: Variation in market value of pension scheme assets owing to interest rates, inflation, credit spreads, and equity and property prices. Character and impact: Pension schemes' funding positions can be volatile due to the uncertainty of future investment returns and the projected value of schemes' liabilities. RBSH Group might have to make financial contributions to, or with respect to, pension schemes.	Refer to pages 108 and 109.

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***Business review** Risk and balance sheet management*

Risk type	Definition	Features	How the RBSH Group managed risk and the focus in 2013
Regulatory risk	The risk arising from non-compliance with regulatory requirements, regulatory change or regulator expectations.	Arises from: Developments in the regulatory environment and RBSH Group's responses to them.	The management of regulatory (as well as conduct) risks in the Bank is overseen by RBS Group's Conduct and Regulatory Affairs function.
		Character and impact: Adverse impact on strategy, capital structure, business models and operational effectiveness.	RBS Group's existing Compliance and Regulatory Affairs teams were brought together in the second half of 2013, following the creation of the role of Group Head of Conduct and Regulatory Affairs. The Conduct and Regulatory Affairs function has responsibility for setting RBS Group wide policy and standards, providing advice to the business and ensuring controls are effective for managing regulatory affairs, compliance and financial crime risks across all businesses.
		Financial impact of adapting to changes in laws, rules or regulations or of penalties for non-compliance.	
		Financial impact and reputational damage in respect of penalties for non-compliance/breach of regulations.	Other enhancements were also made during 2013 included the creation of a more centralised approach to assurance activities and the introduction of a new 'Centres of Excellence' model for the management of regulatory developments, bringing together divisional and functional resources.
Reputational risk	The risk of brand damage and/or financial loss due to the failure to meet stakeholders' expectations of RBSH Group.	Arises from: Actions taken (or, in some cases, not taken) by the RBSH Group, as well as its wider policies and practices.	The Managing Board, supported by all businesses, is responsible for the reputation of RBSH Group. The reputational risk framework is aligned with RBS Group's focus on serving customers well, its strategic objectives and the risk appetite goal of maintaining stakeholder confidence.

Risk appetite measures

		Character and impact: Can result in an inability to build or sustain customer relationships, in low staff morale, in regulatory censure, or in reduced access to funding.	In 2013, the environmental, social and ethical risk management function was set up to address the reputational risk associated with the clients the RBS Group chooses to do business with. It sets policy and provides guidance to avoid reputational risk relating to business engagements and lending to clients in sensitive industry sectors.
Business risk	The risk of losses as a result of adverse variance in the RBSH Group's revenues and/or costs relative to its business plan and strategy.	Arises from: Internal factors such as volatility in pricing, sales volumes and input costs, and/or by external factors such as exposure to macroeconomic, regulatory and industry risks.	Management of business risk is delegated to the CFO, with oversight from RBS Group Finance.
		Character and impact: Can lead to adverse changes in revenues and/or costs.	In 2013 the focus was on controlling RBSH Group's exposure to business risk. RBSH Group's rolling forecast process identified projected changes in, or risks to, operating profit and ensured appropriate action was taken.
Strategic risk	The risk that the RBSH Group will make inappropriate strategic choices.	Arises from: RBSH Group's management of its strategy.	Key strategies are scrutinised and approved by the RBSH Group Board.
		Character and impact: Varied losses affecting earnings, capital, liquidity and customer and stakeholder confidence.	

Each risk type maps into RBSH Group's risk appetite framework and contributes to the overall achievement of its strategic objectives with underlying frameworks and limits. The key frameworks and developments over the past year are described in the relevant sections of the pages that follow.

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Business review Risk and balance sheet management

Capital management*

Introduction

Capital adequacy risk is the risk that the Group has insufficient capital. The Group aims to maintain an appropriate level of capital to meet its business needs and regulatory requirements, and operates within an agreed risk appetite.

The appropriate level of capital is determined based on the dual aims of: (i) meeting minimum regulatory capital requirements; and (ii) ensuring the Group maintains sufficient capital to uphold customer, investor and rating agency confidence in the organisation, thereby supporting the business franchise and funding capacity.

2013 overview

RBSH Group's Tier 1 ratio of 23.2% is higher than the end of 2012, primarily reflecting transfers to RBS plc of businesses in Russia, Romania, Korea and North America. There were also further reductions in the Non-Core portfolio. The de-risking in RBSH Group has been effective in reducing the impacts of stress scenarios and at the same time the capital ratios have been improving, resulting in increased capital buffers. In the second half of 2013 RBSH Group has bought back from the external market a large amount of subordinated Tier 2 capital. As these instruments had a maturity of less than five years, the regulatory impact was limited.

The capital allocation approaches used in RBSH Group will be developed to become increasingly risk sensitive and align risk management and resource allocation more fully.

Governance

Governance and approach

RBSH Group Asset and Liability Management Committee (ALCO) is responsible for ensuring RBSH Group maintains adequate capital at all times. The RBS Group Capital and Stress Testing Committee (CAST) is a cross-functional body driving and directing integrated risk capital activities including determination of the amount of capital RBSH Group should hold, how and where capital is allocated and planning for actions that would ensure that an adequate capital position would be maintained in a stressed environment. These activities have linkages to capital planning, risk appetite and regulatory change. CAST reports through ALCO and comprises senior representatives from RBSH Group Risk, RBSH Group Finance and RBSH Group Treasury.

Determining appropriate capital

The minimum regulatory capital requirements are identified by RBSH Group through the Internal Capital Adequacy Assessment Process and then agreed between Managing Board and the appropriate supervisory authority.

RBSH Group's own determination of how much capital is sufficient is derived from the desired credit rating level, risk appetite and reflects the current and emerging regulatory requirements of RBSH Group.

It is evaluated through the application of both internally and externally defined stress tests that identify potential changes in capital ratios to a range of scenarios.

RBSH Group identifies the management and recovery actions that could be applied to stress environments. These form an important part of the capital management approach and the contingency planning arrangements, complementing the established buffers.

Monitoring and maintenance

Based on these determinations, which are continually reassessed, RBSH Group aims to maintain capital adequacy.

RBSH Group operates a rigorous capital planning process aimed at ensuring the capital position is controlled within the agreed parameters. This incorporates regular re-forecasts of the capital position of RBSH Group. In the event that the projected position deteriorates beyond acceptable levels, RBSH Group would revise business plans accordingly.

Stress testing approaches are used to continually determine the level of capital required to ensure RBSH Group remains adequately capitalised.

Capital allocation

Capital resources are allocated to RBSH Group's businesses based on key performance parameters agreed by the Managing Board in the annual strategic planning process. Principal among these is a profitability metric, which assesses the effective use of the capital allocated to the business. Projected and actual return on equity is assessed against the target returns set by the Managing Board. The allocations also reflect strategic priorities, the intensity of regulatory capital use and the usage of other key RBSH Group resources such as balance sheet and liquidity and funding.

RBSH Group aims to deliver sustainable returns across the portfolio of businesses with projected business returns stressed to test key vulnerabilities.

RBSH Group has regard to the supervisory requirements of De Nederlandsche Bank (DNB). The DNB uses the capital ratio as a measure of capital adequacy in the Netherlands banking sector, comparing a bank's capital resources with its risk-weighted assets (the assets and off-balance sheet exposures are weighted to reflect the inherent credit and other risks); by international agreement, the total capital ratio should be not less than 8% with a Tier 1 capital ratio of not less than 4%.

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Business review Risk and balance sheet management

Capital management*

Capital ratios and risk-weighted assets (RWAs) based on Basel II (CRD III)

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

	2013	2012	2011
Capital ratios	%	%	%
Core Tier 1	20.5	11.7	8.6
Tier 1	23.2	13.9	12.0
Total	26.1	19.8	17.5
	2013	2012	2011
Risk-weighted assets	€m	€m	€m
Credit risk	15,094	26,336	50,197
Market risk (1)	1,171	3,389	5,353
Operational risk	1,088	2,994	3,163
Settlement risk	32	20	—
	17,385	32,739	58,713

Note:

(1) Market risk RWAs in 2011 were largely impacted by the new CRD III rules.

With effect from 30 June 2010, RBSH Group migrated to Basel II status. For the majority of credit risk, RBSH Group uses the advanced internal ratings based approach for calculating RWAs.

Risk-weighted assets for 2013 continued to reduce due to changes in the structure of the balance sheet following the Transfers to RBS plc and reductions in Non-Core.

For operational risk, RBSH Group uses the 2013 basic indicator approach to calculate the operational risk capital charge. The de-risked and reduced size of the RBSH Group has lead to a lower capital charge for operational risk.

The market risk capital charge has been reduced mainly due to further transfers of trading book activities.

Capital ratios are higher than at 31 December 2012, reflecting the reduction in risk-weighted assets discussed above. This is partly offset by lower Tier 2 capital provided from RBSH Group. The transfers have therefore had a more positive impact on Core Tier 1 and Tier 1.

RBSH Group is consolidated for regulatory reporting within RBS Group. Pillar 3 information for RBSH Group is included within the RBS Group Pillar 3 disclosures.

RBS Group publishes its Pillar 3 Disclosures on its website, providing a range of additional information relating to Basel II and risk and capital management across RBS Group. Pillar 3 disclosures provide additional analysis of exposure at default and credit risk measures such as credit risk mitigation, counterparty credit risk and provisions and their associated RWAs under the various Basel II approaches.

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***Business review** Risk and balance sheet management*

Capital management* continued			
Capital resources and flow statement			
RBSH Group's regulatory capital resources were as follows:			
	2013	2012	2011
Composition of regulatory capital	€m	€m	€m
Tier 1			
Controlling interests	2,942	1,799	3,395
Non-controlling interests	—	—	21
Adjustments for			
- Goodwill and other intangible assets	(1)	(4)	(10)
- Unrealised losses on available-for-sale debt securities	883	2,492	3,066
- Unrealised gains on available-for-sale equities	(3)	(19)	(148)
- Other regulatory adjustments	(260)	(442)	(1,298)
Core Tier 1 capital	3,561	3,826	5,026
Innovative/hybrid Tier 1 securities	2,365	2,470	2,511
Less deductions from Tier 1 capital	(1,887)	(1,757)	(475)
Total Tier 1 capital	4,039	4,539	7,062
Tier 2			
Unrealised gains on available-for-sale equities	3	19	148
Subordinated debt	1,552	3,218	3,699
Less deductions from Tier 2 capital	(1,061)	(1,303)	(639)
Total Tier 2 capital	494	1,934	3,208
Total regulatory capital	4,533	6,473	10,270

The table below analyses the movement in Core Tier 1 capital during the year.	
	2013
Movement in Core Tier 1 capital	€m
At 1 January 2013	3,826
Regulatory adjustment - fair value changes in own credit spreads	(115)
Foreign currency reserves	(67)
Loss of non-controlling interest and reduction in goodwill	3
Attributable loss	(135)

Transfer resulting from cross border merger	(246)
Other	295
At 31 December 2013	3,561

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Capital management* continued

Basel III

The rules issued by the Basel Committee on Banking Supervision (BCBS), commonly referred to as Basel III, are a comprehensive set of reforms designed to strengthen the regulation, supervision, risk and liquidity management of the banking sector.

In December 2010, the BCBS issued the final text of the Basel III rules, providing details of the global standards agreed by the Group of Governors and Heads of Supervision, the oversight body of the BCBS and endorsed by the G20 leaders at their November 2010 Seoul summit.

The new capital requirements regulation and capital requirements directive that implement Basel III proposals within the European Union (collectively known as CRD IV) are in two parts, Capital Requirements Directive (CRD) and the Capital Requirements Regulation. Further technical detail will be provided by the European Banking Authority through its Implementing Technical Standards (ITS) and Regulatory Technical Standards.

The CRD IV has been agreed in June 2013 with an implementation date of 1 January 2014. Though some ITS will follow only at a later stage, some only in 2015.

The changes in the definition of regulatory capital under CRD IV and the capital ratios will be subject to transitional rules:

- The increase in the minimum capital ratios and the new buffer requirements will be phased in over the five years from implementation of the CRD IV;

- The application of the regulatory deductions and adjustments at the level of common equity, including the new deduction for deferred tax assets, will also be phased in over the five years from implementation; the current adjustment for unrealised gains and losses on available-for-sale securities will be phased out;

and

- Subordinated debt instruments which do not meet the new eligibility criteria will be will be grandfathered on a reducing basis over ten years.

Other regulatory capital changes

RBSH Group is managing the changes to capital requirements from new regulation and model changes and the resulting impact on the Common Equity Tier 1 ratio, focusing on risk reduction and deleveraging. This is principally being achieved through the transfers to RBS plc, the continued run-off and disposal of Non-Core assets and deleveraging in Markets as the business focuses on the most productive returns on capital.

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

*unaudited

Liquidity and funding risk	
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Liquidity and funding risk

Definition

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

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

Liquidity risk

Policy, framework and governance

The RBSH Group's liquidity policy reflects internal appetite, best market practice and complies with prevailing regulatory structures. These policies are designed to address three broad issues which ensure that:

- The RBSH Group maintains adequate liquid resources at all times to meet liabilities as they fall due.

- The RBSH Group maintains an adequate liquid asset portfolio appropriate to the business activities of the Group and its risk profile.

- The RBSH Group has in place robust strategies, policies, systems, and procedures for identifying, measuring, monitoring and managing liquidity risk.

- The RBSH Group has a comprehensive liquidity risk management framework in place to ensure the Group maintains an appropriate level of financial resources to meet its financial obligations as and when they fall due.

The risk management framework determines the sources of liquidity risk and the steps the RBSH Group can take when these risks exceed certain actively monitored limits. These actions include when and how to use the RBSH Group's liquidity reserves and what other adjustments to the RBSH Group's balance sheet should be undertaken to manage these risks within the RBSH Group's risk appetite.

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

Regulatory oversight*

RBSH Group is subject to the De Nederlandsche Bank's (DNB) supervisory regime for liquidity and each member of RBSH Group also complies with their local regulatory framework for the assessment and management of liquidity risk as well as meeting internal standards.

Measurement and monitoring

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

Overall, RBSH Group's liquidity risk appetite is set by the Managing Board. The RBSH Managing Board's determination and quantification of the appetite for liquidity risk is primarily determined by reference to the Individual Liquidity Adequacy Assessment (ILAA) which includes a comparison of the size of liquidity portfolio to an assessment of stressed outflows. The ILAA also informs the RBSH Board and DNB of the RBSH Group's liquidity risks, their mitigation and about the current and future liquidity profile.

Within the liquidity portfolio the Group holds cash at central banks (€2.4 billion), high quality government securities (€0.1 billion) and collateral eligible for use in central bank operations (€0.9 billion).

Stress testing and contingency planning*

Liquidity stress tests apply scenario-based behavioural and contractual assumptions to cash inflows and outflows to assess the level of liquidity reserves required under a particular scenario.

A stress event can occur when either firm-specific or market-wide factors or a combination of both lead to depositors and investors withdrawing or not renewing funding on maturity. This could be caused by many factors including fears over the viability of the firm. Additionally, liquidity stress can be brought on by customers choosing to draw down on loan agreements and facilities.

Simulated liquidity stress testing is performed at least quarterly for each division as well as the major operating subsidiaries in order to evaluate the strength of the RBSH Group's liquidity risk management.

Stress tests are designed to examine the impact of a variety of firm-specific and market-wide scenarios on the future adequacy of the RBSH Group's liquidity reserves. Stress test scenarios are designed to take into account the RBSH Group's experiences during the financial crisis, recent market conditions and events. These scenarios can be run at any time in response to the emergence of firm-specific or market-wide risks that could have a material impact on the RBSH Group's liquidity position. In the past these have included credit rating changes and political and economic conditions changing in particular countries.

In determining the adequacy of the RBSH Group's liquidity resources the RBSH Group focuses on the outflows it anticipates as a result of any stress scenario occurring. These outflows are measured over certain time periods which extend from two weeks to three months. The RBSH Group is expected to be able to withstand these stressed outflows through its own resources (primarily through the use of the liquidity portfolio) without having to resort to extraordinary central bank or governmental assistance.

The RBSH Group's liquidity risk appetite is measured by reference to the liquidity portfolio as a percentage of stressed contractual and behavioural outflows under the worst of three severe stress scenarios, as prescribed by the PRA. These are a market-wide stress, an idiosyncratic stress and a combination of both.

*unaudited

Business review Risk and balance sheet management

Liquidity and funding risk continued

The RBSH Group has a Contingency Funding Plan (CFP), which is updated at least annually and as the balance sheet evolves and forms the basis of analysis and actions to remediate adverse events as and if they arise. The CFP provides a detailed description of the availability, size and timing of all sources of contingent liquidity available to the Group in a stress event. These are ranked in order of economic impact and effectiveness to meet the anticipated stress requirement. The CFP includes documented processes for actions that may be required to meet the outflows and specifies roles and responsibilities for the effective implementation of the CFP. RBSH Group's CFP is fully integrated with the CFP of RBS Group.

Liquidity reserves

RBSH Group analyses its liquidity portfolio including its locally managed liquidity pools into primary and secondary liquidity groups. The primary liquidity group generally reflects core eligible liquid assets, such as cash and balances at central banks, treasury bills and other high quality government and agency bonds, and other local primary qualifying liquid assets for each of the significant operating subsidiaries that maintain a local liquidity pool. Secondary liquidity assets represent other qualifying liquid assets that are eligible for local central bank liquidity facilities but do not meet the core local regulatory definition.

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

RBSH Group in consultation with the DNB and subject to the applicable limits can change the composition of its liquidity portfolio. The change in composition may relate to market specific factors, changes in internal liquidity risk appetite or regulatory guidance.

Funding risk

Funding sources

As part of the reduction in RBSH Group's balance sheet, RBSH Group's strategy has been to limit access to external funding sources across the globe, including short-term money markets, repurchase agreement markets and term debt investors through its secured and unsecured funding programmes. Funding is now concentrated with RBS Group, who given their active role in the money markets, along with access to global capital flows through its international client base provide funding to ensure RBSH Group's funding is well diversified by currency, geography, maturity and type.

RBSH Group may access various funding facilities offered by central banks from time to time. The use of such facilities can be both part of a wider strategic objective to support initiatives to help stimulate economic growth or as part of RBSH Group's broader liquidity management and funding strategy. Overall usage and repayment of available central bank facilities will fit within RBSH Group's overall liquidity risk appetite and concentration limits contained therein so as not to create outsized maturity exposures. During 2013, RBSH Group repaid the €3.5 billion drawn down under the European Central Banks' Long Term Refinancing Operation.

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

	2013		2012		2011	
	€m	%	€m	%	€m	%
Deposits by banks	7,233	41.0	21,841	64.4	29,988	32.1
Debt securities in issue						
Commercial paper	—	—	8	—	1,563	1.7
Certificates of deposit	—	—	108	0.3	2,326	2.5
Medium term notes and other bonds (including securitisations)	1,319	7.5	2,486	7.4	13,825	14.8
	1,319	7.5	2,602	7.7	17,714	19.0
Subordinated liabilities	4,951	28.1	6,851	20.2	6,859	7.3
Wholesale funding	13,503	76.6	31,294	92.3	54,561	58.4
Customer deposits	4,118	23.4	2,620	7.7	38,842	41.6
Total funding	17,621	100.0	33,914	100.0	93,403	100.0

Key points

- Wholesale funding decreased €17.8 billion to €13.5 billion principally reflecting strategic downsizing in Markets.

- Of the €13.5 billion wholesale funding 44% or €6.0 billion (2012 - €15.9 billion and 50%) related to bank deposits from fellow subsidiaries.

- Repurchase agreement funding from fellow subsidiaries was €11.7 billion at 31 December 2013 (2012 - €12.6 billion).

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Business review Risk and balance sheet management

Business review Risk and balance sheet management

Credit risk

Risk management is conducted on an overall basis within RBS Group. Therefore the discussion on pages 41 to 46 refer principally to policies and procedures in RBS Group that also apply to RBSH Group.

Definition

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

Sources of credit risk

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

Credit risk governance

A strong credit risk management function is vital to support the ongoing profitability of the RBS Group. The potential for loss is mitigated through a robust credit risk culture in the business units and through a focus on sustainable lending practices. The RBS Group's credit risk management function is responsible for credit approval and managing concentration risk as well as credit risk control frameworks and acts as the ultimate authority for the approval of credit. This, together with strong independent oversight and challenge, enables the business to maintain a sound credit environment.

The RBS Group Chief Credit Officer (GCCO), through the RBS Group Credit Risk (GCR) function, is responsible for the development of, and ensuring compliance with, RBS Group-wide policies and credit risk frameworks as well as RBS Group-wide assessment of provision adequacy. The risk management functions, located in the RBS Group's business divisions, are responsible for the execution of these policies.

The divisional credit risk management functions work together with GCR to ensure that the risk appetite set by the RBS Group Board is met. The credit risk function within RBSH Group is managed by the GCR function, through a RBSH Group credit risk delegate who reports to the GCCO. RBSH Group credit risk management activities include credit risk appetite setting, transaction and portfolio analysis, and ongoing credit risk monitoring and oversight.

The Executive Risk Forum (ERF) considers and approves material aspects of the Group's credit risk management framework, such as credit risk appetite and limits for portfolios of strategic significance. The ERF has delegated approval authority to the Group Credit Risk Committee, a functional sub-committee of the Group Risk Committee, to act on credit risk matters. These include, but are not limited to, credit risk appetite and limits (within the overall risk appetite set by the Board and the ERF), credit risk strategy and frameworks, credit risk policy and the oversight of the credit profile across the Group. There are separate Group Credit Risk Committees for the retail and wholesale portfolios and these are chaired by the GCCO.

The RBS Group Audit Committee (GAC) provides oversight of the Group's provision adequacy. The GCCO is accountable to the GAC for the adequacy of the Group's provisions, both individual and collective.

The RBS Group Provisions Committee, which is chaired by either the RBS Group Chief Risk Officer or the GCCO, approves recommendations from the divisional provisions committees.

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

Risk appetite and concentration framework

Risk appetite is set using specific quantitative targets under stress, including earnings volatility and capital adequacy. The RBSH Group's credit risk framework has therefore been designed around the factors that influence the RBSH Group's ability to meet those targets. These include product and asset class, industry sector, single name and country concentrations. Any of these factors could generate higher earnings volatility under stress and, if not adequately controlled, could undermine capital adequacy. Tools such as stress testing and economic capital are used to measure credit risk volatility and develop links between RBSH Group risk appetite targets and the credit risk control framework. The frameworks are supported by a suite of RBS Group-wide and divisional policies that set out the risk parameters within which divisions must operate. The RBS Group also manages its exposures to counterparty credit risk closely, using portfolio limits and specific tools to control more volatile or capital intensive business areas.

Wholesale

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

Risk appetite measures

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

Risk management*

Product/asset class concentration framework

The RBS Group manages certain lines of business where the nature of credit risk assumed could result in a concentration or a heightened risk in some other form. This includes specific credit risk types such as settlement or wrong-way risk and products such as long-dated derivatives or securitisations. These product and asset classes may require formal policies and expertise as well as tailored monitoring and reporting measures. In some cases specific limits and thresholds are deployed to ensure that the credit risk inherent in these lines of business and products is adequately controlled. Product and asset classes are reviewed regularly. The reviews consider the risks inherent in each product or asset class, the risk controls applied, monitoring and reporting of the risk, the client base, and any emerging risks to ensure risk appetite remains appropriate.

*unaudited

Ready-mixed concrete (cubic yards)	
	711
	660

Three Months Ended March 31, 2006 and 2005 Construction materials and mining experienced a normal seasonal first quarter loss of $8.9 million. The seasonal loss increased by $400,000 from $8.5 million in 2005. The increased seasonal loss was due to operating losses from companies acquired since the comparable prior period largely offset by improvements from existing operations of $1.5 million. The improvements at existing operations were due to higher realized ready-mixed concrete prices; increased construction margins due to increased construction activity; and increased aggregate margins, the result of higher volumes.

Independent Power Production

	Three Months Ended March 31, 2006	2005
	(Dollars in millions)	
Operating revenues	$ 11.3	$ 9.8
Operating expenses:		
Fuel and purchased power	.3	---
Operation and maintenance	9.2	6.4
Depreciation, depletion and amortization	2.4	2.5
Taxes, other than income	.9	.7
	12.8	9.6
Operating income (loss)	(1.5)	.2
Earnings	$ 1.3	$ .7
Net generation capacity (kW)*	389,600	279,600
Electricity produced and sold (thousand kWh)*	88,497	37,250

* Excludes equity method investments.

Three Months Ended March 31, 2006 and 2005 Earnings at the independent power production business increased $600,000 largely due to:

· Higher earnings from equity method investments which reflect:

- A one-time benefit due to a tax rate reduction, which affected the segment's generating facility located in Trinidad
- Absence in 2006 of expenses incurred at the Termoceara Generating Facility of $600,000 (after tax), which was sold in June of 2005

The increase was offset in part by lower margins of $800,000 (after tax) related to a domestic electric generating facility due primarily to lower capacity revenues.

Other and Intersegment Transactions

Amounts presented in the preceding tables will not agree with the Consolidated Statements of Income due to the Company's other operations and the elimination of intersegment transactions. The amounts relating to these items are as follows:

	Three Months Ended March 31, 2006	2005
	(In millions)	
Other:		
Operating revenues	$ 1.8	$ 1.4
Operation and maintenance	1.3	1.2
Depreciation, depletion and amortization	.2	.1
Taxes, other than income	---	.1
Intersegment transactions:		
Operating revenues	$ 108.0	$ 77.0
Purchased natural gas sold	101.2	72.6
Operation and maintenance	6.8	4.4

For further information on intersegment eliminations, see Note 14.

PROSPECTIVE INFORMATION

The following information includes highlights of the key growth strategies, projections and certain assumptions for the Company and its subsidiaries and other matters for each of the Company's businesses. Many of these highlighted points are forward-looking statements. There is no assurance that the Company's projections, including estimates for growth and increases in revenues and earnings, will in fact be achieved. Please refer to assumptions contained in this section, as well as the various important factors listed in Part II, Item 1A - Risk Factors, as well as Part I, Item 1A - Risk Factors in the 2005 Annual Report. Changes in such assumptions and factors could cause actual future results to differ materially from targeted growth, revenue and earnings projections.

MDU Resources Group, Inc.

- Earnings per common share for 2006, diluted, are projected in the range of $2.15 to $2.35, an increase from prior guidance of $2.00 to $2.20.

- The Company expects the percentage of 2006 earnings per common share, diluted, by quarter to be in the following approximate ranges:
  - Second quarter - 20 percent to 25 percent
  - Third quarter - 30 percent to 35 percent
  - Fourth quarter - 25 percent to 30 percent

- The Company's long-term compound annual growth goals on earnings per share are in the range of 7 percent to 10 percent, although the Company has exceeded this level in recent years.

Electric

- The Company is analyzing potential projects for accommodating load growth and replacing an expiring purchased power contract with Company-owned generation. This will add to the Company's base-load capacity and rate base. New generation is projected to be on line by 2011. A decision on the project to be built is anticipated by early 2007.

- This business continues to pursue growth by expanding energy-related services.

- Montana-Dakota has obtained and holds, or is in the process of renewing, valid and existing franchises authorizing it to conduct its electric operations in all of the municipalities it serves where such franchises are required.

Montana-Dakota intends to protect its service area and seek renewal of all expiring franchises.

Natural gas distribution

· In September 2004, a natural gas rate case was filed with the MPUC requesting an increase of $1.4 million annually, or approximately 4.0 percent. For further information, see Note 16.

· Montana-Dakota's and Great Plains' retail natural gas rate schedules contain clauses permitting monthly adjustments in rates based upon changes in natural gas commodity, transportation and storage costs. Current regulatory practices allow Montana-Dakota and Great Plains to recover increases or refund decreases in such costs within a period ranging from 24 to 28 months from the time such costs are paid. At March 31, 2006, the MTPSC has not issued a final order relative to the last three years of monthly gas cost changes that were implemented on an interim basis. A proceeding is under way and a final ruling is expected by late 2006.

· This business continues to pursue growth by expanding energy-related services.

· Montana-Dakota and Great Plains have obtained and hold, or are in the process of renewing, valid and existing franchises authorizing them to conduct their natural gas operations in all of the municipalities they serve where such franchises are required. Montana-Dakota and Great Plains intend to protect their service areas and seek renewal of all expiring franchises.

Construction services

· Revenues in 2006 are expected to be higher than 2005 record levels.

· The Company anticipates margins to strengthen in 2006 as compared to 2005 levels.

· Work backlog as of March 31, 2006, was approximately $439 million including acquisitions, compared to $226 million at March 31, 2005.

Pipeline and energy services

· Firm capacity for the Grasslands Pipeline is 90,000 Mcf per day with expansion possible to 200,000 Mcf per day. Based on anticipated demand, incremental expansions are forecasted over the next few years beginning as early as 2007.

· In 2006, total gathering and transportation throughput is expected to increase approximately 5 percent over 2005 levels.

Natural gas and oil production

· The Company's long-term compound annual growth goals for production are in the range of 7 percent to 10 percent. In 2006, the Company expects to exceed the upper end of this range. These estimates exclude production from the recent acquisition of oil and natural gas properties located in the Big Horn Basin of Wyoming.

· The Company is expecting to drill more than 300 wells in 2006. Currently, this segment's net combined natural gas and oil production is approximately 200,000 Mcf equivalent to 210,000 Mcf equivalent per day. These items exclude production from the recent acquisition of oil and natural gas properties located in the Big Horn Basin of Wyoming.

· Estimates of natural gas prices in the Rocky Mountain region for May through December 2006 reflected in the Company's 2006 earnings guidance are in the range of $5.50 to $6.00 per Mcf. The Company's estimates for natural gas prices on the NYMEX for May through December 2006, reflected in the Company's 2006 earnings guidance, are in the range of $6.75 to $7.25 per Mcf. During 2005, more than three-fourths of this segment's natural gas production was priced using Rocky Mountain or other non-NYMEX prices.

· Estimates of NYMEX crude oil prices for May through December 2006, reflected in the Company's 2006 earnings guidance, are projected in the range of $55 to $60 per barrel.

· The Company has hedged approximately 30 percent to 35 percent of its estimated natural gas production and 20 percent to 25 percent of its estimated oil production for the last nine months of 2006. For 2007, the Company has hedged approximately 10 percent to 15 percent of its estimated natural gas production. These items exclude production from the recent acquisition of oil and natural gas properties located in the Big Horn Basin of Wyoming. The hedges that are in place as of May 1, 2006, for 2006 and 2007 are summarized in the following chart:

Commodity	Index*	Period Outstanding	Forward Notional Volume (MMBtu)/(Bbl)	Price Swap or Costless Collar Floor-Ceiling (Per MMBtu/Bbl)
Natural Gas	Ventura	4/06 - 12/06	1,375,000	$6.00-$7.60
Natural Gas	Ventura	4/06 - 12/06	2,750,000	$6.655
Natural Gas	Ventura	4/06 - 12/06	1,375,000	$6.75-$7.71
Natural Gas	Ventura	4/06 - 12/06	1,375,000	$6.75-$7.77
Natural Gas	Ventura	4/06 - 12/06	1,375,000	$7.00-$8.85
Natural Gas	NYMEX	4/06 - 12/06	1,375,000	$7.75-$8.50
Natural Gas	Ventura	4/06 - 12/06	1,375,000	$7.76
Natural Gas	CIG	4/06 - 12/06	1,375,000	$6.50-$6.98
Natural Gas	CIG	4/06 - 12/06	1,375,000	$7.00-$8.87
Natural Gas	Ventura	4/06 - 12/06	687,500	$8.50-$10.00
Natural Gas	Ventura	4/06 - 12/06	687,500	$8.50-$10.15
Natural Gas	Ventura	4/06 - 10/06	1,070,000	$9.25-$12.88
Natural Gas	Ventura	4/06 - 10/06	1,070,000	$9.25-$12.80
Natural Gas	Ventura	1/07 - 12/07	1,825,000	$8.00-$11.91
Natural Gas	Ventura	1/07 - 12/07	912,500	$8.00-$11.80
Natural Gas	Ventura	1/07 - 12/07	912,500	$8.00-$11.75
Natural Gas	Ventura	1/07 - 12/07	1,825,000	$7.50-$10.55
Natural Gas	CIG	1/07 - 12/07	1,825,000	$7.40
Natural Gas	CIG	1/07 - 12/07	1,825,000	$7.405
Crude Oil	NYMEX	4/06 - 12/06	137,500	$43.00-$54.15
Crude Oil	NYMEX	4/06 - 12/06	110,000	$60.00-$69.20
Crude Oil	NYMEX	4/06 - 12/06	68,750	$60.00-$76.80

* Ventura is an index pricing point related to Northern Natural Gas Co.'s system; CIG is an index pricing point related to Colorado Interstate Gas Co.'s system.

Construction materials and mining

· Ready-mixed concrete, aggregate and asphalt volumes for 2006 are expected to be higher than the record levels achieved in 2005.

· Work backlog as of March 31, 2006, was approximately $610 million including acquisitions, compared to $527 million at March 31, 2005.

· A key element of the Company's long-term strategy for this business is to further expand its presence in the higher-margin materials business (rock, sand, gravel, etc.), complementing the Company's ongoing efforts to increase margin by building a more profitable backlog of business and carefully managing costs.

· Strong market and product demand, cost containment initiatives and continued operational improvement in Texas are expected to result in improved margins over 2005.

· Five of the labor contracts that Knife River was negotiating, as reported in Items 1 and 2 - Business and Properties - General in the Company's 2005 Annual Report remain in negotiations. Two have been ratified.

Independent power production

· Earnings at this segment are expected to be minimal in 2006, primarily reflecting the sale of the Company's Brazilian electric generating facility in June 2005, significantly higher interest expense related to the construction of the Hardin Generating Facility and lower revenues because of the bridge contract renewal at the Brush Generating Facility.

· The Hardin Generating Facility was placed into commercial operation in March 2006 at a competitive construction cost and has demonstrated an output above 120 MW gross through the successful design, construction and operation of the plant. All electricity generated by the plant is sold to Powerex Corp. (a wholly owned subsidiary of BC Hydro) under a power purchase agreement expiring October 31, 2008, with the purchaser having an option for a two-year extension.

· This segment continues to explore opportunities for investments both domestically and internationally, using the corporation's disciplined approach for acquisitions. The Company is focused on redeploying the funds from the June 2005 sale of the Brazilian facility into strategic assets.

NEW ACCOUNTING STANDARDS

For information regarding new accounting standards, see Note 9, which is incorporated by reference.

CRITICAL ACCOUNTING POLICIES INVOLVING SIGNIFICANT ESTIMATES

The Company's critical accounting policies involving significant estimates include impairment testing of long-lived assets and intangibles, impairment testing of natural gas and oil production properties, revenue recognition, purchase accounting, asset retirement obligations, and pension and other postretirement benefits. There were no material changes in the Company's critical accounting policies involving significant estimates from those reported in the 2005 Annual Report. For more information on critical accounting policies involving significant estimates, see Part II, Item 7 in the 2005 Annual Report.

LIQUIDITY AND CAPITAL COMMITMENTS

Cash flows

Operating activities The changes in cash flows from operating activities generally follow the results of operations as discussed in Financial and Operating Data and also are affected by changes in working capital. Cash flows provided by operating activities in the first three months of 2006 decreased $19.9 million from the comparable 2005 period, reflecting the result of increased working capital requirements of $45.1 million, largely at the following businesses:

· Natural gas distribution, due largely to timing of natural gas costs recoverable through rate adjustments and higher natural gas costs

· Construction services, primarily due to higher receivables reflecting increased construction activity

· Construction materials and mining, due in part to higher asphalt oil and fuel inventories in preparation for the upcoming construction season

Partially offsetting the decrease in cash flows from operating activities were:

· Increased net income of $18.9 million, largely increased earnings at the natural gas and oil production, construction services and pipeline and energy services businesses

·

Higher deferred income taxes of $10.8 million, primarily related to natural gas costs recoverable through rate adjustments and costs associated with the redemption of certain first mortgage bonds at the electric and natural gas distribution businesses, as well as higher property, plant and equipment at the natural gas and oil production business
- Higher depreciation, depletion and amortization expense of $10.6 million, largely at the natural gas and oil production business, as previously discussed

Investing activities Cash flows used in investing activities in the first three months of 2006 increased $39.7 million compared to the comparable 2005 period, the result of increased capital expenditures primarily at the natural gas and oil production business, largely due to additional exploration in South Texas, and higher ongoing capital expenditures at the construction materials and mining business.

Financing activities Cash flows provided by financing activities in the first three months of 2006 increased $14.7 million compared to the comparable 2005 period, primarily the result of an increase in the issuance of long-term debt of $42.0 million, partially offset by an increase in the repayment of long-term debt of $28.8 million.

Defined benefit pension plans
There are no material changes to the Company’s qualified noncontributory defined benefit pension plans (Pension Plans) from those reported in the 2005 Annual Report. For further information on the Company’s Pension Plans, see Note 15.

Capital expenditures
Net capital expenditures for the first three months of 2006 were $115.5 million and are estimated to be approximately $620 million for the year 2006. Estimated capital expenditures include those for:

- Completed acquisitions
- System upgrades
- Routine replacements
- Service extensions
- Routine equipment maintenance and replacements
- Buildings, land and building improvements
- Pipeline and gathering projects
- Further enhancement of natural gas and oil production and reserve growth
- Power generation opportunities, including certain costs for additional electric generating capacity
- Other growth opportunities

Approximately 22 percent of estimated 2006 net capital expenditures are associated with completed acquisitions, including the acquisition discussed in Note 19. The Company continues to evaluate potential future acquisitions and other growth opportunities; however, they are dependent upon the availability of economic opportunities and, as a result, capital expenditures may vary significantly from the estimated 2006 capital expenditures referred to previously. It is anticipated that all of the funds required for capital expenditures will be met from various sources, including internally generated funds; commercial paper credit facilities at Centennial and MDU Resources Group, Inc., as described below; and through the issuance of long-term debt and the Company’s equity securities.

Capital resources
Certain debt instruments of the Company and its subsidiaries, including those discussed below, contain restrictive covenants, all of which the Company and its subsidiaries were in compliance with at March 31, 2006.

MDU Resources Group, Inc. The Company has a revolving credit agreement with various banks totaling $100 million (with provision for an increase, at the option of the Company on stated conditions, up to a maximum of $125 million). There were no amounts outstanding under the credit agreement at March 31, 2006. The credit agreement supports the Company’s $100 million commercial paper program. Under the Company’s commercial paper program, $98.0 million was outstanding at March 31, 2006. The commercial paper borrowings are classified as long-term debt as they are intended to be refinanced on a long-term basis through continued commercial paper borrowings (supported by the credit agreement, which expires in June 2010). The Company plans to borrow up to $100 million through the issuance of unsecured notes later this year. These funds are expected to be used primarily to pay down commercial paper borrowings.

The Company’s objective is to maintain acceptable credit ratings in order to access the capital markets through the issuance of commercial paper. Minor fluctuations in the Company’s credit ratings have not limited, nor would they be expected to limit, the Company’s ability to access the capital markets. In the event of a minor downgrade, the Company may experience a nominal basis point increase in overall interest rates with respect to its cost of borrowings. If the Company were to experience a significant downgrade of its credit ratings, it may need to borrow under its credit agreement.

To the extent the Company needs to borrow under its credit agreement, it would be expected to incur increased annualized interest expense on its variable rate debt of approximately $147,000 (after tax) based on March 31, 2006, variable rate borrowings.

Prior to the maturity of the credit agreement, the Company expects that it will negotiate the extension or replacement of this agreement. If the Company is unable to successfully negotiate an extension of, or replacement for, the credit agreement, or if the fees on this facility became too expensive, which the Company does not currently anticipate, the Company would seek alternative funding. One source of alternative funding might involve the securitization of certain Company assets.

In order to borrow under the Company’s credit agreement, the Company must be in compliance with the applicable covenants and certain other conditions, including covenants not to permit, as of the end of any fiscal quarter, (A) the ratio of funded debt to total capitalization (determined on a consolidated basis) to be greater than 65 percent or (B) the ratio of funded debt to capitalization (determined with respect to the Company alone, excluding its subsidiaries) to be greater than 65 percent. Also included is a covenant that does not permit the ratio of the Company's earnings before interest, taxes, depreciation and amortization to interest expense (determined with respect to the Company alone, excluding its subsidiaries), for the 12-month period ended each fiscal quarter, to be less than 2.5 to 1. Other covenants include restrictions on the sale of certain assets and on the making of certain investments. The Company was in compliance with these covenants and met the required conditions at March 31, 2006. In the event the Company does not comply with the applicable covenants and other conditions, alternative sources of funding may need to be pursued, as previously described.

There are no credit facilities that contain cross-default provisions between the Company and any of its subsidiaries.

The Company's issuance of first mortgage debt is subject to certain restrictions imposed under the terms and conditions of its Indenture of Mortgage. Generally, those restrictions require the Company to fund $1.43 of unfunded property or use $1.00 of refunded bonds for each dollar of indebtedness incurred under the Indenture and, in some cases, to certify to the trustee that annual earnings (pretax and before interest charges), as defined in the Indenture, equal at least two times its annualized first mortgage bond interest costs. Under the more restrictive of the tests, as of March 31, 2006, the Company could have issued approximately $433 million of additional first mortgage bonds.

The Company's coverage of fixed charges including preferred dividends was 6.2 times and 6.1 times for the 12 months ended March 31, 2006 and December 31, 2005, respectively. Additionally, the Company's first mortgage bond interest coverage was 26.3 times and 10.2 times for the 12 months ended March 31, 2006 and December 31, 2005, respectively. Common stockholders' equity as a percent of total capitalization (net of long-term debt due within one year) was 63 percent at both March 31, 2006 and December 31, 2005.

The Company has repurchased, and may from time to time seek to repurchase, outstanding first mortgage bonds through open market purchases or privately negotiated transactions. The Company will evaluate any such transactions in light of then existing market conditions, taking into account its liquidity and prospects for future access to capital. Between January 1 and March 31, 2006, the Company repurchased $68.0 million of first mortgage bonds. As of March 31, 2006, the Company had $57.0 million of first mortgage bonds outstanding, $30 million of which were held by the Indenture trustee for the benefit of the Senior Note holders. At such time as the aggregate principal amount of the Company's outstanding first mortgage bonds, other than those held by the Indenture trustee, is $20 million or less, the Company would have the ability, subject to satisfying certain specified conditions, to require that any debt issued under its Indenture, dated as of December 15, 2003, as supplemented, from the Company to The Bank of New York, as trustee, become unsecured and rank equally with all of the Company's other unsecured and unsubordinated debt (as of March 31, 2006, the only such debt outstanding under the Indenture was $30.0 million in aggregate principal amount of the Company's 5.98% Senior Notes due in 2033).

Centennial Energy Holdings, Inc. Centennial has three revolving credit agreements with various banks and institutions totaling $441.4 million with certain provisions allowing for increased borrowings. These credit agreements support Centennial's $400 million (previously $350 million) commercial paper program. There were no outstanding borrowings under the Centennial credit agreements at March 31, 2006. Under the Centennial commercial paper program, $185.5 million was outstanding at March 31, 2006. The Centennial commercial paper borrowings are classified as long-term debt as Centennial intends to refinance these borrowings on a long-term basis through continued Centennial commercial paper borrowings (supported by Centennial credit agreements). One of these credit agreements is for $400 million, which includes a provision for an increase, at the option of Centennial on stated conditions, up to a maximum of $450 million and expires on August 26, 2010. Another agreement is for $21.4 million and expires on April 30, 2007. Pursuant to this credit agreement, on the last business day of April 2006, the line of credit will be reduced by $3.6 million. Centennial intends to negotiate the extension or replacement of these agreements prior to their maturities. The third agreement is an uncommitted line for $20 million, which was effective on January 27, 2006, and may be terminated by the bank at any time. As of March 31, 2006, $39.7 million of letters of credit were outstanding, as discussed in Note 17, of which $24.4 million were outstanding under the above credit agreements that reduced amounts available under these agreements.

Centennial has an uncommitted long-term master shelf agreement that allows for borrowings of up to $450 million. Under the terms of the master shelf agreement, $447.5 million was outstanding at March 31, 2006. The ability to request additional borrowings under this master shelf agreement expires in April 2008. To meet potential future financing needs, Centennial may pursue other financing arrangements, including private and/or public financing.

Centennial's objective is to maintain acceptable credit ratings in order to access the capital markets through the issuance of commercial paper. Minor fluctuations in Centennial's credit ratings have not limited, nor would they be expected to limit, Centennial's ability to access the capital markets. In the event of a minor downgrade, Centennial may experience a nominal basis point increase in overall interest rates with respect to its cost of borrowings. If Centennial were to experience a significant downgrade of its credit ratings, it may need to borrow under its committed bank lines.

To the extent Centennial needs to borrow under its committed bank lines, it would be expected to incur increased annualized interest expense on its variable rate debt of approximately $278,000 (after tax) based on March 31, 2006, variable rate borrowings. Based on Centennial's overall interest rate exposure at March 31, 2006, this change would not have a material effect on the Company's results of operations or cash flows.

Prior to the maturity of the Centennial credit agreements, Centennial expects that it will negotiate the extension or replacement of these agreements, which provide credit support to access the capital markets. In the event Centennial was unable to successfully negotiate these agreements, or in the event the fees on such facilities became too expensive, which Centennial does not currently anticipate, it would seek alternative funding. One source of alternative funding might involve the securitization of certain Centennial assets.

In order to borrow under Centennial's credit agreements and the Centennial uncommitted long-term master shelf agreement, Centennial and certain of its subsidiaries must be in compliance with the applicable covenants and certain other conditions, including covenants not to permit, as of the end of any fiscal quarter, the ratio of total debt to total capitalization to be greater than 65 percent (for the $400 million credit agreement) and 60 percent (for the $21.4 million credit agreement and the master shelf agreement). Also included is a covenant that does not permit the ratio of Centennial's earnings before interest, taxes, depreciation and amortization to interest expense, for the 12-month period ended each fiscal quarter, to be less than 2.5 to 1 (for the $400 million credit agreement), 2.25 to 1 (for the $21.4 million credit agreement) and 1.75 to 1 (for the master shelf agreement). Other covenants include minimum consolidated net worth, limitation on priority debt and restrictions on the sale of certain assets and on the making of certain loans and investments. Centennial and such subsidiaries were in compliance with these covenants and met the required conditions at March 31, 2006. In the event Centennial or such subsidiaries do not comply with the applicable covenants and other conditions, alternative sources of funding may need to be pursued as previously described.

Certain of Centennial's financing agreements contain cross-default provisions. These provisions state that if Centennial or any subsidiary of Centennial fails to make any payment with respect to any indebtedness or contingent obligation, in excess of a specified amount, under any agreement that causes such indebtedness to be due prior to its stated maturity or the contingent obligation to become payable, the applicable agreements will be in default. Certain of Centennial's financing agreements and Centennial's practice limit the amount of subsidiary indebtedness.

Williston Basin Interstate Pipeline Company Williston Basin has an uncommitted long-term master shelf agreement that allows for borrowings of up to $100 million. Under the terms of the master shelf agreement, $55.0 million was outstanding at March 31, 2006. The ability to request additional borrowings under this master shelf agreement expires on December 20, 2007.

In order to borrow under its uncommitted long-term master shelf agreement, Williston Basin must be in compliance with the applicable covenants and certain other conditions, including covenants not to permit, as of the end of any fiscal quarter, the ratio of total debt to total capitalization to be greater than 55 percent. Other covenants include limitation on priority debt and some restrictions on the sale of certain assets and the making of certain investments. Williston Basin was in compliance with these covenants and met the required conditions at March 31, 2006. In the event Williston Basin does not comply with the applicable covenants and other conditions, alternative sources of funding may need to be pursued.

Off balance sheet arrangements

In connection with the sale of MPX in June 2005 to Petrobras, an indirect wholly owned subsidiary of the Company has agreed to indemnify Petrobras for 49 percent of any losses that Petrobras may incur from certain contingent liabilities specified in the purchase agreement. Centennial has agreed to unconditionally guarantee payment of the indemnity obligations to Petrobras for periods ranging from approximately two to five and a half years from the date of sale. The guarantee was required by Petrobras as a condition to closing the sale of MPX.

Contractual obligations and commercial commitments

There are no material changes in the Company's contractual obligations relating to long-term debt from those reported in the 2005 Annual Report.

The Company's contractual obligations relating to operating leases at March 31, 2006, increased $13.9 million or 23 percent from December 31, 2005. Contractual obligations relating to purchase commitments at March 31, 2006, were $808.1 million compared to purchase commitments of $935.0 million at December 31, 2005, a decrease of 14 percent. At March 31, 2006, the Company's contractual obligations related to operating leases and purchase commitments (for the twelve months ended March 31, of each year listed in the table below) were as follows:

	2007	2008	2009	2010	2011	Thereafter	Total
				(In millions)			

Operating leases	$	14.5	$	10.2	$	8.3	$	7.0	$	5.7	$	27.6	$	73.3
Purchase commitments		257.3		108.4		61.8		56.8		55.8		268.0		808.1

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company is exposed to the impact of market fluctuations associated with commodity prices and interest rates. The Company has policies and procedures to assist in controlling these market risks and utilizes derivatives to manage a portion of its risk.

Commodity price risk
Fidelity utilizes natural gas and oil price swap and collar agreements to manage a portion of the market risk associated with fluctuations in the price of natural gas and oil on its forecasted sales of natural gas and oil production. For more information on commodity price risk, see Part II, Item 7A in the 2005 Annual Report, and Notes 10 and 13.

The following table summarizes hedge agreements entered into by Fidelity as of March 31, 2006. These agreements call for Fidelity to receive fixed prices and pay variable prices.

(Notional amount and fair value in thousands)

		Weighted Average Fixed Price (Per MMBtu)	Forward Notional Volume (In MMBtu's)		Fair Value
Natural gas swap agreements maturing in 2006	$	7.02	4,125	$	(406)
Natural gas swap agreements maturing in 2007	$	7.40	3,650	$	(680)

		Weighted Average Floor/Ceiling Price (Per MMBtu)	Forward Notional Volume (In MMBtu's)		Fair Value
Natural gas collar agreements maturing in 2006	$	7.39/$9.04	13,140	$	9,394
Natural gas collar agreements maturing in 2007	$	7.83/$11.41	5,475	$	1,168

		Weighted Average Floor/Ceiling Price (Per barrel)	Forward Notional Volume (In barrels)		Fair Value
Oil collar agreements maturing in 2006	$	52.61/$64.31	316	$	(2,435)

For further information on Fidelity's natural gas and oil price swap and collar agreements, see Note 13.

Interest rate risk
There were no material changes to interest rate risk faced by the Company from those reported in the 2005 Annual Report. For more information on interest rate risk, see Part II, Item 7A in the 2005 Annual Report.

Foreign currency risk
The Company's investment in the Termoceara Generating Facility was sold in June 2005 as discussed in Note 11 and, as a result, the Company no longer has any material exposure to foreign currency exchange risk.

ITEM 4. CONTROLS AND PROCEDURES

The following information includes the evaluation of disclosure controls and procedures by the Company’s chief executive officer and the chief financial officer, along with any significant changes in internal controls of the Company.

Evaluation of disclosure controls and procedures
The term "disclosure controls and procedures" is defined in Rules 13a-15(e) and 15d-15(e) of the Exchange Act. These rules refer to the controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports it files under the Exchange Act is recorded, processed, summarized and reported within required time periods. The Company’s chief executive officer and chief financial officer have evaluated the effectiveness of the Company’s disclosure controls and procedures and they have concluded that, as of the end of the period covered by this report, such controls and procedures were effective.

Changes in internal controls
The Company maintains a system of internal accounting controls that is designed to provide reasonable assurance that the Company’s transactions are properly authorized, the Company’s assets are safeguarded against unauthorized or improper use, and the Company’s transactions are properly recorded and reported to permit preparation of the Company’s financial statements in conformity with generally accepted accounting principles in the United States of America. There were no changes in the Company’s internal control over financial reporting that occurred during the period covered by this report that have materially affected, or are reasonably likely to materially affect, the Company’s internal control over financial reporting.

PART II -- OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

For information regarding legal proceedings, see Note 17, which is incorporated by reference.

ITEM 1A. RISK FACTORS

This Form 10-Q contains forward-looking statements within the meaning of Section 21E of the Exchange Act. Forward-looking statements are all statements other than statements of historical fact, including without limitation those statements that are identified by the words "anticipates," "estimates," "expects," "intends," "plans," "predicts" and similar expressions.

The Company is including the following factors and cautionary statements in this Form 10-Q to make applicable and to take advantage of the safe harbor provisions of the Private Securities Litigation Reform Act of 1995 for any forward-looking statements made by, or on behalf of, the Company. Forward-looking statements include statements concerning plans, objectives, goals, strategies, future events or performance, and underlying assumptions (many of which are based, in turn, upon further assumptions) and other statements that are other than statements of historical facts. From time to time, the Company may publish or otherwise make available forward-looking statements of this nature, including statements contained within Prospective Information. All these subsequent forward-looking statements, whether written or oral and whether made by or on behalf of the Company, also are expressly qualified by these factors and cautionary statements.

Forward-looking statements involve risks and uncertainties, which could cause actual results or outcomes to differ materially from those expressed. The Company's expectations, beliefs and projections are expressed in good faith and are believed by the Company to have a reasonable basis, including without limitation, management's examination of historical operating trends, data contained in the Company's records and other data available from third parties.

Nonetheless, the Company's expectations, beliefs or projections may not be achieved or accomplished.

Any forward-looking statement contained in this document speaks only as of the date on which the statement is made, and the Company undertakes no obligation to update any forward-looking statement or statements to reflect events or circumstances that occur after the date on which the statement is made or to reflect the occurrence of unanticipated events. New factors emerge from time to time, and it is not possible for management to predict all of the factors, nor can it assess the effect of each factor on the Company's business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statement.

There are no material changes in the Company’s risk factors from those reported in Part I, Item 1A - Risk Factors of the 2005 Annual Report other than the risk associated with the ongoing litigation and administrative proceedings in connection with the Company’s coalbed natural gas development activities, as discussed below. These factors and the other matters discussed herein are important factors that could cause actual results or outcomes for the Company to differ materially from those discussed in the forward-looking statements included elsewhere in this document.

Environmental and Regulatory Risks
One of the Company’s subsidiaries is subject to ongoing litigation and administrative proceedings in connection with its coalbed natural gas development activities. These proceedings have caused delays in coalbed natural gas drilling activity, and the ultimate outcome of the actions could have a material effect on existing coalbed natural gas operations and/or the future development of its coalbed natural gas properties.

Fidelity has been named as a defendant in, and/or certain of its operations are or have been the subject of, more than a dozen lawsuits filed in connection with its coalbed natural gas development in the Powder River Basin in Montana and Wyoming. If the plaintiffs are successful in these lawsuits, the ultimate outcome of the actions could have a material effect on Fidelity's existing coalbed natural gas operations and/or the future development of its coalbed natural gas properties.

The BER conducted rulemaking proceedings, in response to a petition filed by the NPRC, on whether to promulgate rules that would (1) require re-injection of water produced in connection with coalbed natural gas operations and treatment of such water in the event re-injection is not feasible and (2) amend the non-degradation policy in connection with coalbed natural gas development to include additional limitations on factors deemed harmful, thereby restricting discharges even further than under existing standards. While the BER, in March 2006, rejected the NPRC’s proposed requirements on re-injection and treatment, it did adopt a non-degradation policy that could adversely impact Fidelity’s operations, depending on applicability of the new policy to water discharge permits issued to Fidelity by the Montana DEQ prior to the latest action of the BER. Fidelity believes that the previously issued permits, if they remain in effect though their specified five-year terms, should allow Fidelity to continue to conduct its existing coalbed natural gas operations without undue operational constraints. However, the Northern Cheyenne Tribe filed suit in Montana state court, in April 2006, seeking to have the permits set aside. If the permits are determined to be invalid, Fidelity’s existing coalbed natural gas operations would likely be materially and adversely affected.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

The following table includes information with respect to the issuer's purchase of equity securities:

ISSUER PURCHASES OF EQUITY SECURITIES

	(a) Total Number of Shares	(b) Average Price Paid per Share	(c) Total Number of Shares (or Units) Purchased as Part of Publicly	(d) Maximum Number (or Approximate Dollar Value) of Shares (or

Period	(or Units) Purchased (1)	(or Unit)	Announced Plans or Programs (2)	Units) that May Yet Be Purchased Under the Plans or Programs (2)
January 1 through January 31, 2006				
February 1 through February 28, 2006	37,533	$34.65		
March 1 through March 31, 2006				
Total	37,533			

(1) Represents shares of common stock withheld by the Company to pay taxes in connection with the vesting of shares granted pursuant to a compensation plan.

(2) Not applicable. The Company does not currently have in place any publicly announced plans or programs to purchase equity securities.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

The Company's Annual Meeting of Stockholders was held on April 25, 2006. Three proposals were submitted to stockholders as described in the Company's Proxy Statement dated March 9, 2006, and were voted upon and approved by stockholders at the meeting. The table below briefly describes the proposals and the results of the stockholder votes.

	Shares For	Shares Against or Withheld	Abstentions	Broker Non-Votes
Proposal to elect three directors:				
For terms expiring in 2009 --				
Richard H. Lewis	106,484,336	1,154,261	---	---
Harry J. Pearce	106,107,037	1,531,560	---	---
Sister Thomas Welder, O.S.B.	105,948,733	1,689,864	---	---
Proposal to ratify the appointment of Deloitte & Touche LLP as the Company's independent auditors for 2006	106,526,040	749,359	363,198	---
Proposal to approve the Long-Term Performance-Based Incentive Plan	61,306,898	19,532,043	1,556,394	25,243,262

ITEM 6. EXHIBITS

10(a) Employment Agreement between the Company and John K. Castleberry

10(b) Long-Term Performance-Based Incentive Plan, as amended February 16, 2006

10(c) Form of Performance Share Award Agreement under the Long-Term Performance-Based Incentive Plan

10(d) 1997 Non-Employee Director Long-Term Incentive Plan, as amended February 16, 2006

10(e) WBI Holdings, Inc. Executive Incentive Compensation Plan, as amended effective January 1, 2006

12 Computation of Ratio of Earnings to Fixed Charges and Combined Fixed Charges and Preferred Stock Dividends

31(a) Certification of Chief Executive Officer filed pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

31(b) Certification of Chief Financial Officer filed pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

32 Certification of Chief Executive Officer and Chief Financial Officer furnished pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

SIGNATURES

Pursuant to the requirements of the Exchange Act, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

MDU RESOURCES GROUP, INC.

DATE: May 5, 2006

BY: /s/ Vernon A. Raile
Vernon A. Raile
Executive Vice President, Treasurer and Chief Financial Officer

BY: /s/ Doran N. Schwartz
Doran N. Schwartz
Vice President and Chief Accounting Officer

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