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RBS
The Royal Bank of Scotland

SME Customer Charter
A Guide to Lending Pricing

Our SME Customer Charter commits us to be open and transparent across a range of fronts including lending pricing. Over the last two years the average interest cost of borrowing for our SME customers has fallen significantly from 7.5% in 2007 to 3.4% in the third quarter of 2009. This has been driven by a number of factors, including a significant reduction in base rates which has more than offset increases in our longer term funding costs and in our credit costs. This simple guide has been created to explain, in easy to understand terms, these different factors which determine the cost of your borrowing. It is part of our series of helpful guides. Other guides can be found on our website **rbs.co.uk/business**

1. Our funding costs

- Like any business, a major determinant of our pricing is the cost of our raw materials. For a bank, that means how much it costs us to gather the money that funds our lending.
- We raise the money we lend to you from a wide range of sources. One important source is the short-term wholesale lending market, known as the London interbank market, where banks lend money to each other. In 2008 and the first half of 2009 interest rates on this market, known as Libor rates, rose far above the Bank of England's official base rate (the Bank Rate), which is currently 0.5%. The difference between the two has reduced in recent months.
- Short-term wholesale rates (e.g. Libor), however, represent only a part of our funding costs. To be able to provide longer term loans to customers, we also need to borrow in longer term wholesale markets. The cost of borrowing in these markets is significantly higher than for short-term funding at the moment. In addition, we must offer interest rates high enough to attract retail and commercial deposits to help fund our business. These can represent more stable sources of funding but currently cost us far more than Bank Rate, particularly for longer term funding.

2. Our credit costs

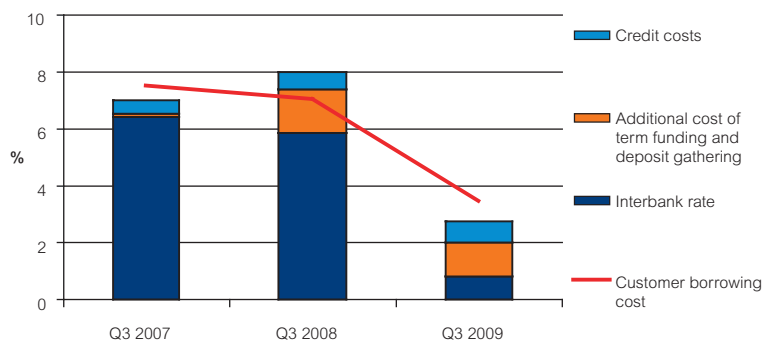
- We carry out a credit assessment on every customer who wants to borrow from us. If we think there is a high probability that a customer will not be able to afford the loan, we may not be able to lend as much as a customer has requested or may refuse to lend, but in many cases we cannot predict the exact outcome.
- We may know from past experience that out of every 100 loans we make to small businesses, between two and three are likely to default, but we cannot know in advance precisely which ones will do so. For loans where we believe the risk of default is greater, we will charge more to help cover the possible losses on that loan.
- In setting the price of your loan, we have to take into account the credit costs we incur when customers default on their loans. In today's more difficult economic environment, these credit costs have risen. In many instances we will ask you to provide some form of security or guarantee for the loans we provide. The stronger that security, the lower the interest rate we will charge as this helps protect us from any potential losses.

3. Our capital costs

- From the margin that remains after our funding and credit costs, we must, like any business, cover our operating costs and make a return for our shareholders.
- Bank regulators require us to set aside a certain amount of equity capital for every loan we make, and that capital requirement has almost doubled over the last 18 months, as regulators are justifiably keen to ensure that banks maintain much stronger capital bases than in the past. The more capital we have to hold, the greater the return we need to make to pay back our investors – including our largest shareholder, the UK Government.

All of the above factors influence the cost of borrowing to our SME customers. While the reduction in Bank Rate has helped us to halve the rates we charge our customers over the last two years, we also had to absorb significant increases in the overall costs of longer term wholesale and retail funding, as well as in credit costs. At RBS, our focus is, and will continue to be, providing competitively priced lending to our customers.

Illustration – The Factors Influencing Loan Pricing



Note: the above graph showing factors influencing loan pricing does not take account of operating costs or costs of capital.

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