

ROYAL BANK OF SCOTLAND GROUP PLC
Form 424B5
December 17, 2013

CALCULATION OF REGISTRATION FEE

Title of Each Class of Securities Offered	Maximum Aggregate Offering Price	Amount of Registration Fee(1)
6.00% Subordinated Tier 2 Notes due 2023	\$2,000,000,000	\$257,600
Total	\$2,000,000,000	\$257,600

(1) Calculated in accordance with Rule 457(r) of the Securities Act of 1933, as amended

Filed pursuant to Rule 424(b)(5)
Registration No. 333-184147

PROSPECTUS SUPPLEMENT

(to prospectus dated September 28, 2012)

The Royal Bank of Scotland Group plc

\$2,000,000,000

6.00% Subordinated Tier 2 Notes due 2023

The 6.00% Subordinated Tier 2 Notes due 2023 will be due on December 19, 2023 (the “Subordinated Notes”) and will bear interest at a rate of 6.00% per year from (and including) the date of issuance to (but excluding) the maturity of the Subordinated Notes on December 19, 2023. Interest will be paid on the Subordinated Notes on June 19 and December 19 of each year, commencing on June 19, 2014.

The Subordinated Notes will constitute our direct, unconditional, unsecured and subordinated obligations ranking pari passu without any preference among themselves and ranking junior in right of payment to the claims of any existing and future unsecured and unsubordinated indebtedness. In a winding up or in the event that an administrator has been appointed in respect of us and notice has been given that it intends to declare and distribute a dividend, all payments on the Subordinated Notes will be subordinated to, and subject in right of payment to the prior payment in full of, all claims of all of our creditors other than claims in respect of any liability that is, or is expressed to be, subordinated to the claims of all or any of our creditors, whether only in the event of a winding up or otherwise. The ranking of our obligations shall be set out in the manner provided in the subordinated indenture between The Royal Bank of Scotland Group plc (“RBSG”) and The Bank of New York Mellon, acting through its London Branch, as trustee (the “Trustee”), dated December 4, 2012 (the “Base Subordinated Indenture”), as supplemented by a first supplemental indenture dated December 4, 2012 (the “First Supplemental Subordinated Indenture”) and a third supplemental indenture to be dated December 19, 2013 (the “Third Supplemental Subordinated Indenture” and, together with the First Supplemental Subordinated Indenture and the Base Subordinated Indenture, the “Subordinated Indenture”).

In addition, by purchasing the Subordinated Notes, each holder (including each beneficial holder) of the Subordinated Notes acknowledges, agrees to be bound by and consents to the exercise of any U.K. bail-in power (as defined below) by the relevant U.K. resolution authority that may result in (i) the cancellation of all, or a portion, of the principal amount of, or interest on, the Subordinated Notes and/or (ii) the conversion of all, or a portion, of the principal amount of, or interest on, the Subordinated Notes into shares or other securities or other obligations of RBSG or another person, which U.K. bail-in power may be exercised by means of variation of the terms of the Subordinated Notes

solely to give effect to the above. With respect to (i) and (ii) above, references to principal and interest shall include payments of principal and interest that have become due and payable (including principal that has become due and payable at the Maturity Date), but which have not been paid, prior to the exercise of any U.K. bail-in power. Each holder of the Subordinated Notes further acknowledges and agrees that the rights of the holders under the Subordinated Notes are subject to, and will be varied, if necessary, solely to give effect to, the exercise of any U.K. bail-in power by the relevant U.K. resolution authority expressed to implement such a cancellation or conversion.

For these purposes, a “U.K. bail-in power” is any write-down and/or conversion power existing from time to time under any laws, regulations, rules or requirements relating to the resolution of banks, banking group companies, credit institutions and/or investment firms incorporated in the United Kingdom in effect and applicable in the United Kingdom to RBSG or other members of the Group (as defined herein), including but not limited to any such laws, regulations, rules or requirements which are implemented, adopted or enacted within the context of a European Union directive or regulation of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms and/or within the context of a U.K. resolution regime by way of amendment to the Banking Act 2009 or otherwise, pursuant to which obligations of a bank, banking group company, credit institution or investment firm or any of its affiliates can be reduced, cancelled, transferred and/or converted into shares or other

securities or obligations of the obligor or any other person (and a reference to the “relevant U.K. resolution authority” is to any authority with the ability to exercise a U.K. bail-in power).

By purchasing the Subordinated Notes, each holder (including each beneficial holder) of the Subordinated Notes, to the extent permitted by the Trust Indenture Act of 1939 as amended (the “Trust Indenture Act”), waives any and all claims against the Trustee for, agrees not to initiate a suit against the Trustee in respect of, and agrees that the Trustee shall not be liable for, any action that the Trustee takes, or abstains from taking, in either case in accordance with the exercise of the U.K. bail-in power by the relevant U.K. resolution authority with respect to the Subordinated Notes.

We may redeem the Subordinated Notes, in whole but not in part, at 100% of their principal amount plus accrued but unpaid interest (i) upon the occurrence of certain tax events or (ii) upon the occurrence of certain regulatory events, provided that, in each case, in our opinion, the circumstance that entitles us to exercise such right of redemption was not reasonably foreseeable to us at the date of issuance and provided that upon CRD IV (as defined below) taking effect in the United Kingdom, such right of redemption shall only apply if, when and to the extent not prohibited by CRD IV, as described in this prospectus supplement or the accompanying prospectus. Any such redemption shall be subject to a requirement to give notice to or obtain the consent of the U.K. Prudential Regulation Authority (“PRA”) and/or such other body having supervisory authority with respect to us to the extent required, as described in this prospectus supplement.

We intend to apply to list the Subordinated Notes on the New York Stock Exchange in accordance with its rules.

Investing in the Subordinated Notes involves risks. See “Risk Factors” beginning on page S-9 and as incorporated by reference herein.

By its purchase of the Subordinated Notes, each holder (including each beneficial holder) shall be deemed to have (i) consented to the exercise of any U.K. bail-in power as it may be imposed without any prior notice by the relevant U.K. resolution authority of its decision to exercise such power with respect to the Subordinated Notes and (ii) authorized, directed and requested The Depositary Trust Company (“DTC”) and any direct participant in DTC or other intermediary through which it holds such Subordinated Notes to take any and all necessary action, if required, to implement the exercise of any U.K. bail-in power with respect to the Subordinated Notes as it may be imposed, without any further action or direction on the part of such holder.

Neither the Securities and Exchange Commission nor any other regulatory body has approved or disapproved of these securities or passed upon the accuracy or adequacy of this prospectus supplement or the accompanying prospectus. Any representation to the contrary is a criminal offense.

	Per Subordinated Note	Total
Price to the public	99.098%	\$ 1,981,960,000
Underwriting discounts	0.400%	\$ 8,000,000
Proceeds, before expenses, to us	98.698%	\$ 1,973,960,000

The initial price to public set forth above does not include accrued interest, if any. Interest on the Subordinated Notes will accrue from December 19, 2013 and must be paid by the purchaser if the Subordinated Notes are delivered thereafter.

We expect that the Subordinated Notes will be ready for delivery through the book-entry facilities of DTC and its participants on or about December 19, 2013.

Global Co-ordinator and Structuring Advisor, Joint Bookrunner and Joint Lead Manager

RBS

Joint Bookrunners and Joint Lead Managers

Credit Suisse

J.P. Morgan

Morgan Stanley

Co-Managers

BMO Capital Markets

BNY Mellon Capital Markets, LLC

Capital One Securities

CIBC

Citigroup

Danske Markets Inc.

Mischler Financial Group, Inc.

RBC Capital Markets

TD Securities

Wells Fargo Securities

Prospectus Supplement dated December 16, 2013

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We have not authorized anyone to provide any information other than that contained or incorporated by reference in this prospectus supplement and the accompanying prospectus or in any free writing prospectus prepared by or on behalf of us or to which we have referred you. We take no responsibility for, and can provide no assurance as to the reliability of, any other information that others may give you. We are not making an offer to sell these securities in any state or jurisdiction where the offer or sale is not permitted. You should assume that the information contained in this prospectus supplement, the accompanying prospectus and the documents incorporated by reference herein is

accurate only as of their respective dates.

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ABOUT THIS PROSPECTUS SUPPLEMENT

In this prospectus supplement, we use the following terms:

- “we”, “us”, “our”, “Issuer” and “RBSG” mean The Royal Bank of Scotland Group plc;
- “Group” means RBSG together with its subsidiaries consolidated in accordance with International Financial Reporting Standards;
 - “RBS plc” means The Royal Bank of Scotland plc;
 - “SEC” refers to the Securities and Exchange Commission;
 - “pounds”, “sterling”, “pence”, “£” and “p” refer to the currency of the United Kingdom;
 - “dollars” and “\$” refer to the currency of the United States; and
- “euro” and “€” refer to the currency of the member states of the European Union (“EU”) that have adopted the single currency in accordance with the treaty establishing the European Community, as amended.

INCORPORATION OF INFORMATION BY REFERENCE

We are subject to the informational requirements of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), and in accordance therewith, we file reports and other information with the SEC. You may read and copy any document that we file with the SEC at the SEC’s Public Reference Room, 100 F Street, N.E., Washington, D.C. 20549. You can call the SEC on 1-800-SEC-0330 for further information about the Public Reference Room. The SEC’s website, at <http://www.sec.gov>, contains reports and other information in electronic form that we have filed. You may also request a copy of any filings referred to below (other than exhibits not specifically incorporated by reference) at no cost, by contacting us at RBS Gogarburn, P.O. Box 1000, Edinburgh EH12 1HQ, Scotland, telephone +44 131 626 0000.

The SEC allows us to incorporate by reference much of the information we file with them. This means:

- incorporated documents are considered part of this prospectus supplement;
- we can disclose important information to you by referring you to these documents; and
- information that we file with the SEC will automatically update and modify or supersede some of the information included or incorporated by reference into this prospectus supplement.

This means that you must look at all of the SEC filings that we incorporate by reference to determine if any of the statements in this prospectus supplement or in any document previously incorporated by reference have been modified or superseded. The accompanying prospectus lists documents that are incorporated by reference into this prospectus supplement. In addition to the documents listed in the accompanying prospectus, we incorporate by reference:

- our Annual Report on Form 20-F for the year ended December 31, 2012 filed with the SEC on March 27, 2013 (File No. 001-10306) (the “2012 Annual Report”);

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- our interim results on Form 6-K for the half-year ended June 30, 2013 filed with the SEC on August 30, 2013 (File No. 001-10306) (the “H1 2013 Interim Report”);
- our interim results on Form 6-K for the nine-months ended September 30, 2013 filed with the SEC on November 7, 2013 (File No. 001-10306) (the “Q3 2013 Interim Report”);
- our announcement on Form 6-K relating to the appointment of Robert Gillespie as a Non-executive Director of RBS, filed with the SEC on 28 November, 2013 (File No. 001-10306);

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- our announcement on Form 6-K relating to the settlement reached with the European Commission with respect to competition law breaches concerning certain interest rate derivatives referenced to the London Interbank Offered Rate based on Japanese Yen (Yen LIBOR) and the Euro Interbank offered Rate (EURIBOR), filed with the SEC on December 4, 2013 (File No. 001-10306);
- our announcement on Form 6-K confirming Nathan Bostock's announcement to the Board of his intention to resign from his role as Group Finance Director, filed with the SEC on December 11, 2013 (File No. 001-10306); and
- our announcement on Form 6-K relating to the settlement reached with the Board of Governors of the Federal Reserve System ("Fed"), the New York State Department of Financial Services ("DFS"), and the Office of Foreign Assets Control ("OFAC") with respect to RBS plc's historical compliance with US economic sanction regulations outside the United States, filed with the SEC on December 11, 2013 (File No. 001-10306).

We also incorporate by reference into this prospectus supplement and accompanying prospectus any future documents we may file with the SEC under Section 13(a), 13(c), 14 or 15(d) of the Exchange Act from the date of this prospectus supplement until the offering contemplated in this prospectus supplement is completed. Reports on Form 6-K we may furnish to the SEC after the date of this prospectus supplement (or portions thereof) are incorporated by reference in this prospectus supplement only to the extent that the report expressly states that it (or such portions) is incorporated by reference in this prospectus supplement.

FORWARD-LOOKING STATEMENTS

From time to time, we may make statements, both written and oral, regarding our assumptions, projections, expectations, intentions or beliefs about future events. These statements constitute “forward-looking statements” for purposes of the Private Securities Litigation Reform Act of 1995. We caution that these statements may and often do vary materially from actual results. Accordingly, we cannot assure you that actual results will not differ materially from those expressed or implied by the forward-looking statements. You should read the sections entitled “Risk Factors” in this prospectus supplement, “Cautionary Statement on Forward-Looking Statements” in the accompanying prospectus and “Forward-Looking Statements” in our 2012 Annual Report, our H1 2013 Interim Report and our Q3 2013 Interim Report, which are incorporated by reference herein.

Any forward-looking statements made herein or in the documents incorporated by reference herein speak only as of the date they are made. Except as required by the Financial Conduct Authority, any applicable stock exchange or any applicable law, we expressly disclaim any obligation or undertaking to release publicly any updates or revisions to any forward-looking statement contained in this prospectus supplement or the documents incorporated by reference herein to reflect any changes in expectations with regard thereto or any new information or any changes in events, conditions or circumstances on which any such statement is based. The reader should, however, consult any additional disclosures that we have made or may make in documents we have filed or may file with the SEC.

SUMMARY

The following is a summary of this prospectus supplement and should be read as an introduction to, and in conjunction with, the remainder of this prospectus supplement, the accompanying prospectus and any documents incorporated by reference herein and therein. You should base your investment decision on a consideration of this prospectus supplement, the accompanying prospectus and any documents incorporated by reference herein and therein, as a whole. Words and expressions defined in “Description of the Subordinated Notes” below shall have the same meanings in this summary.

General

Issuer	The Royal Bank of Scotland Group plc
Subordinated Notes	\$2,000,000,000 aggregate principal amount of the 6.00% subordinated Tier 2 notes due 2023 (the “Subordinated Notes”).
Issue Date	December 19, 2013
Maturity Date	We will pay the Subordinated Notes at 100% of their principal amount plus accrued and unpaid interest on December 19, 2023 subject to any early redemption as described in “Description of the Subordinated Notes—Redemption”.
Interest Rate	The Subordinated Notes will bear interest from (and including) the Issue Date at a rate of 6.00% per annum.
Interest Payment Dates	June 19 and December 19 in each year, commencing on June 19, 2014.
Regular Record Dates	Every June 5 and December 5 of each year, commencing on June 5, 2014.
Ranking	The Subordinated Notes will constitute our direct, unconditional, unsecured and subordinated obligations ranking pari passu, without any preference among themselves and ranking junior in right of payment to the claims of any existing and future unsecured and unsubordinated indebtedness. In a winding up or in the event that an administrator has been appointed in respect of us and notice has been given that it intends to declare and distribute a dividend, all payments on the Subordinated Notes will be subordinated to, and subject in right of payment to the prior payment in full of, all claims of all of our creditors other than claims in respect of any liability that is, or is expressed to be, subordinated to the claims of all or any of our creditors, whether only in the event of a winding up or otherwise. The ranking of our obligations shall be set out in the manner provided in the Subordinated Indenture.
Agreement with Respect to the Exercise of U.K. Bail-in Power	By purchasing the Subordinated Notes, each holder (including each beneficial holder) of the Subordinated Notes acknowledges, agrees to be bound by and consents to the exercise of any U.K. bail-in power (as defined below) by the relevant U.K. resolution authority that may result in (i) the cancellation of all, or a portion, of the principal amount of, or interest on, the Subordinated Notes and/or (ii) the conversion of all, or a portion, of the principal amount of, or interest on, the Subordinated Notes into shares or other securities or other obligations of RBSG or another person, which U.K. bail-in power may be exercised by means of variation of the terms of the Subordinated Notes solely to give effect to the above. With respect to (i) and (ii) above, references to principal and interest shall include payments of principal and interest that have become due and payable (including principal that has become due and payable at the Maturity Date), but which have not been paid, prior to the exercise of any U.K. bail-in power. Each

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holder of the Subordinated Notes further acknowledges and agrees that the rights of the holders under the Subordinated Notes are subject to, and will be varied, if necessary, solely to give effect to, the exercise of any U.K. bail-in power by the relevant U.K. resolution authority expressed to implement such a cancellation or conversion.

For these purposes, a “U.K. bail-in power” is any write-down and/or conversion power existing from time to time under any laws, regulations, rules or requirements relating to the resolution of banks, banking group companies, credit institutions and/or investment firms incorporated in the United Kingdom in effect and applicable in the United Kingdom to us or other members of the Group, including but not limited to any such laws, regulations, rules or requirements which are implemented, adopted or enacted within the context of a European Union directive or regulation of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms and/or within the context of a U.K. resolution regime by way of amendment to the Banking Act 2009 or otherwise, pursuant to which obligations of a bank, banking group company, credit institution or investment firm or any of its affiliates can be reduced, cancelled, transferred and/or converted into shares or other securities or obligations of the obligor or any other person (and a reference to the “relevant U.K. resolution authority” is to any authority with the ability to exercise a U.K. bail-in power).

Repayment of Principal and Payment of Interest After Exercise of U.K. Bail-in Power	No repayment of the principal amount of the Subordinated Notes or payment of interest on the Subordinated Notes shall become due and payable after the exercise of any U.K. bail-in power by the relevant U.K. resolution authority unless, at the time that such repayment or payment, respectively, is scheduled to become due, such repayment or payment would be permitted to be made by us under the laws and regulations of the United Kingdom and the European Union applicable to us or other members of the Group.
Purchases of the Subordinated Notes	We may at any time purchase beneficially or procure others to purchase beneficially for our account the Subordinated Notes in the open market, by tender or by private agreement, provided that, upon CRD IV (as defined below) taking effect in the United Kingdom, purchases are only permitted if, when and to the extent not prohibited by CRD IV. Any such purchase will be subject to a requirement to give notice to or obtain the consent of the PRA, as set forth below under “Description of the Subordinated Notes—Redemption—Prudential Regulation Authority” in this prospectus supplement.
Cancellation	Subordinated Notes purchased or otherwise acquired by us may be (i) held, (ii) resold or (iii) at our sole discretion, surrendered to the Trustee for cancellation (in which case all Subordinated Notes so surrendered will forthwith be cancelled in accordance with applicable law and thereafter may not be re-issued or resold).
Additional Issuances	We may, from time to time, without the consent of the holders of the Subordinated Notes, issue additional notes under the Subordinated Indenture, having the same ranking and same interest rate, maturity date, redemption terms and other terms, except for the price to the public and issue date. Any such additional notes, together with the Subordinated Notes offered by this prospectus supplement, may constitute a single series of Subordinated Notes under the Subordinated Indenture, provided that if such additional notes have the same CUSIP, ISIN or other identifying number as the outstanding Subordinated Notes, such additional notes must be fungible

	with the Subordinated Notes for U.S. federal income tax purposes.
Tax Redemption	We may redeem the Subordinated Notes at any time, in whole but not in part, at 100% of their principal amount plus accrued but unpaid interest, in the event of certain changes in the tax laws of the United Kingdom and in other limited circumstances as described under “Description of the Subordinated Notes—Redemption—Tax Redemption” in this prospectus supplement and “Description of Debt Securities—Redemption” in the accompanying prospectus, provided that, in our opinion, the circumstance that entitles us to exercise such right of redemption was not reasonably foreseeable to us at the Issue Date and provided that upon CRD IV (as defined herein) taking effect in the United Kingdom, such right of redemption shall only apply if, when and to the extent not prohibited by CRD IV. Any such redemption will be subject to a requirement to give notice to or obtain the consent of the PRA, as set forth below under “Description of the Subordinated Notes—Redemption—Prudential Regulation Authority” in this prospectus supplement.
Regulatory Redemption	We may redeem the Subordinated Notes at any time, in whole but not in part, at 100% of their principal amount plus accrued and unpaid interest, in the event of certain regulatory changes that result in the principal amount of the Subordinated Notes being fully excluded from inclusion in our Tier 2 capital, as described under “Description of the Subordinated Notes—Redemption—Redemption due to a Capital Disqualification Event” in this prospectus supplement, provided that, in our opinion, the circumstance that entitles us to exercise such right of redemption was not reasonably foreseeable to us at the Issue Date and provided that upon CRD IV taking effect in the United Kingdom, such right of redemption shall only apply if, when and to the extent not prohibited by CRD IV. Any such redemption will be subject to a requirement to give notice to or obtain the consent of the PRA, as set forth below under “Description of the Subordinated Notes—Redemption—Prudential Regulation Authority” in this prospectus supplement.
Book-Entry Issuance, Settlement and Clearance	We will issue the Subordinated Notes in fully registered form in denominations of \$2,000 and integral multiples of \$1,000 in excess thereof. The Subordinated Notes will be represented by one or more global securities registered in the name of a nominee of The Depository Trust Company (“DTC”). You will hold beneficial interests in the Subordinated Notes through DTC and its direct and indirect participants, including Euroclear S.A./NV (“Euroclear”) and Clearstream Banking, société anonyme (“Clearstream Banking”) and DTC and its direct and indirect participants will record your beneficial interest on their books. We will not issue certificated notes except as described in the accompanying prospectus. Settlement of the Subordinated Notes will occur through DTC in same day funds. For information on DTC’s book-entry system, see “Description of Debt Securities—Form of Debt Securities; Book-Entry System” in the accompanying prospectus.
Business Day Convention	Following unadjusted.
Day Count Fraction	30/360
ISIN	US780097AZ42
CUSIP	780097AZ4
Conflicts of Interest	RBS Securities Inc. (“RBSSI”), an affiliate of RBSG, is a Financial Industry Regulatory Authority (“FINRA”) member and an Underwriter in

this offering and has a “conflict of interest” within the meaning of FINRA Rule 5121. Accordingly, this offering will be made in compliance with the applicable provisions of FINRA Rule 5121. RBSSI is not permitted to sell Subordinated Notes in this offering to an account over which it exercises discretionary authority without the prior specific written approval of the account holder.

Listing and Trading	We intend to apply to list the Subordinated Notes on the New York Stock Exchange in accordance with its rules.
Trustee and Principal Paying Agent	The Bank of New York Mellon, acting through its London Branch, a banking corporation duly organized and existing under the laws of the State of New York, as trustee (the “Trustee”), having its Corporate Trust Office at One Canada Square, London E14 5AL, United Kingdom, will act as the trustee and initial principal paying agent for the Subordinated Notes.
Timing and Delivery	We currently expect delivery of the Subordinated Notes to occur on December 19, 2013.
Use of Proceeds	We intend to use the net proceeds of the offering for general corporate purposes. See “Use of Proceeds”.
Governing Law	The Subordinated Indenture and the Subordinated Notes will be governed by, and construed in accordance with, the laws of the State of New York except that, as the Subordinated Indenture specifies, the subordination provisions and the waiver of the right to set-off by the holders and by the Trustee acting on behalf of the holders with respect to the Subordinated Notes will be governed by and construed in accordance with the laws of Scotland.

RISK FACTORS

Prospective investors should consider carefully the risk factors incorporated by reference into this prospectus supplement and as set out below as well as the other information set out elsewhere in this prospectus supplement (including any other documents incorporated by reference herein) and reach their own views prior to making any investment decision with respect to the Subordinated Notes.

Set out below and incorporated by reference herein are certain risk factors that could have a material adverse effect on the business, operations, financial condition or prospects of RBSG and cause RBSG's future results to be materially different from expected results. RBSG's results could also be affected by competition and other factors. These factors should not be regarded as a complete and comprehensive statement of all potential risks and uncertainties RBSG faces. RBSG has described only those risks relating to its operations that it considers to be material. There may be additional risks that RBSG currently considers not to be material or of which it is not currently aware, and any of these risks could have the effects set forth above. All of these factors are contingencies which may or may not occur and RBSG is not in a position to express a view on the likelihood of any such contingency occurring. Investors should note that they bear RBSG's solvency risk. Each of the risks highlighted could have a material adverse effect on the amount of principal and interest which investors will receive in respect of the Subordinated Notes. In addition, each of the highlighted risks could adversely affect the trading price of the Subordinated Notes or the rights of investors under the Subordinated Notes and, as a result, investors could lose some or all of their investment. You should consult your own financial, tax and legal advisers regarding the risks of an investment in the Subordinated Notes.

We believe that the factors described below with respect to the Subordinated Notes represent the principal risks inherent in investing in Subordinated Notes, but we may be unable to pay interest, principal or other amounts on or in connection with the Subordinated Notes for other reasons, including as a result of the exercise of any U.K. bail-in power, and we do not represent that the statements below regarding the risks of holding the Subordinated Notes are exhaustive. Prospective investors should also read the detailed information set out elsewhere in this prospectus supplement (including any documents deemed to be incorporated by reference herein) and reach their own views prior to making any investment decision.

Risks relating to RBSG

For a description of risks associated with RBSG as well as certain risks associated with investments in RBSG's securities, see the section entitled "Risk Factors" in our 2012 Annual Report, our H1 2013 Interim Report and our Q3 2013 Interim Report which are incorporated by reference herein.

Risks relating to the Subordinated Notes

RBSG's obligations under the Subordinated Notes are subordinated

The obligations of RBSG under the Subordinated Notes will be unsecured and subordinated and will rank junior in priority of payment to the current and future claims of RBSG's creditors, other than claims in respect of any liability that is, or is expressed to be, subordinated. We expect from time to time to incur additional indebtedness or other obligations that will constitute senior indebtedness, and the Subordinated Indenture does not contain any provisions restricting our ability to incur senior indebtedness. Although the Subordinated Notes may pay a higher rate of interest than comparable notes which are not so subordinated, there is a real risk that an investor in such Subordinated Notes will lose all or some of its investment should RBSG become insolvent since the assets of RBSG would be available to pay such amounts only after all the senior creditors of RBSG have been paid in full. See also "The Subordinated Notes are the subject of the U.K. bail-in power which may result in your Subordinated Notes being written down to zero or

converted into other securities, including equity securities”.

The Subordinated Notes are obligations exclusively of RBSG

The Subordinated Notes are obligations exclusively of RBSG. RBSG is a holding company and conducts substantially all of its operations through its subsidiaries. RBSG’s subsidiaries are separate and distinct legal entities, and have no obligation to pay any amounts due or to provide RBSG with funds to meet any of its payment obligations. RBSG’s rights to participate in the assets of any subsidiary if it is liquidated will be subject to the prior claims of its creditors.

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The Subordinated Notes are the subject of the U.K. bail-in power which may result in your Subordinated Notes being written down to zero or converted into other securities, including equity securities

The Basel Committee on Banking Supervision (the “Basel Committee”) proposed a number of fundamental reforms to the regulatory capital framework for internationally active banks which are designed, in part, to ensure that capital instruments issued by such banks fully absorb losses before tax payers are exposed to loss (the “Basel III Reforms”). The Basel III Reforms provide that all non-common equity Tier 1 instruments and Tier 2 instruments, such as the Subordinated Notes, which do not contain any contractual terms providing for their writing off or conversion into ordinary shares, at the option of the relevant authority, upon the occurrence of a Non-Viability Event (as defined below), would cease to be eligible to count in full as Additional Tier 1 or Tier 2 capital (as the case may be) from January 1, 2013 unless, among other things, the jurisdiction of the relevant bank has in place laws that (i) require such instruments to be written off upon the occurrence of a Non-Viability Event or (ii) otherwise require such instruments fully to absorb losses before tax payers are exposed to loss.

The principal elements of the Basel III Reforms will be implemented in the European Union under CRD IV (as defined below) and such reforms are now expected to become effective on January 1, 2014 and are subject to a series of transitional arrangements and are expected to be fully effective by 2019. On August 2, 2013, the PRA published its consultation paper (CP5/13: Strengthening Capital Standards: Implementing CRD IV) setting out the proposed changes to the PRA’s rules to implement CRD IV in the United Kingdom and relevant discretions provided in CRD IV. The final PRA policy statement and rules are expected to be published in December 2013, after approval by the PRA Board.

As used above, “Non-Viability Event” means the earlier of (a) a decision that a write off, without which the relevant bank would become non-viable, is necessary as determined by the relevant authority; and (b) the decision to make a public sector injection of capital, or equivalent support, without which the relevant bank would have become non-viable, as determined by the relevant authority.

On June 6, 2012, the European Commission published a legislative proposal for a directive providing for the establishment of an EU-wide framework for the recovery and resolution of credit institutions and investment firms, known as the Recovery and Resolution Directive (the “RRD”) which has been subsequently subject to amendment but has not yet been adopted. On June 27, 2013, at a meeting of the Economic and Financial Affairs Council, the Council of the European Union agreed its position on the RRD. The EU Member States and the European Parliament reached a political agreement as announced on December 12, 2013 on the RRD (which remains subject to technical finalization and formal approval by the co-legislators) and current expectations are that the RRD will be finalized early in 2014. The stated aim of the draft RRD is to provide supervisory authorities with common tools and powers to address banking crises pre-emptively in order to safeguard financial stability and minimize taxpayers’ exposure to losses. The powers proposed to be granted to supervisory authorities under the draft RRD include a “bail-in” tool, which would give such authorities the power to write down or write off the claims (potentially including the Subordinated Notes) of certain unsecured creditors of a failing institution and/or to convert certain debt claims to equity. Except for the general bail-in tool, which is now expected to be implemented by January 1, 2016, it is currently contemplated that the measures set out in the draft RRD (including the power of authorities to write off Additional Tier 1 and Tier 2 instruments) will be implemented with effect from January 1, 2015. As the RRD is not in final form changes may be made to it in the course of the legislative process.

On October 1, 2013, the U.K. Government published amendments to the Financial Services (Banking Reform) Bill, amended further on October 24, 2013 (the “Banking Reform Bill”), which include amendments to the Banking Act 2009 to insert a bail-in option among the powers of the U.K. resolution authority. The bail-in option will be introduced as an additional power available to the Bank of England, to enable it to recapitalize a failed institution by allocating losses to its shareholders and unsecured creditors in a manner that seeks to respect the hierarchy of claims in

liquidation. The bail-in option includes the power to cancel or write-down a liability such as the Subordinated Notes, to modify the form of a liability (including, for example, the power to convert the Subordinated Notes into equity) or to provide that a contract under which the institution has a liability is to have effect as if a specified right had been exercised under it, each for the purposes of reducing, deferring or cancelling the liabilities of the bank under resolution, as well as to transfer a liability. The conditions for use of the bail-in option are, in summary, that (i) the regulator determines that the bank is failing or likely to fail, (ii) it is not reasonably likely that any other action can be taken to avoid the bank's failure and (iii) the U.K. resolution authority determines that the exercise of such power is necessary having regard to the public interest. The Banking Reform Bill is consistent with the range of tools that Member States will be required to make available to their resolution authorities under the RRD. It is

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expected that the Banking Reform Bill will be passed by the U.K. Parliament in early 2014 and, thereafter, the U.K. Treasury will stipulate the date on which the majority of the provisions will enter into force.

The Subordinated Notes include a provision in which holders agree to be bound by the exercise of any U.K. bail-in power. In addition to the RRD and the amendments to the Banking Act 2009 by way of the Banking Reform Bill described above, it is possible that the application of other relevant laws, the Basel III Reforms (including the EU's implementation of the Basel III Reforms) or other similar regulatory proposals, could be used in such a way as to result in the Subordinated Notes absorbing losses in the manner described above. The determination that all or part of the principal amount of the Subordinated Notes will be subject to loss absorption is likely to be inherently unpredictable and may depend on a number of factors which may be outside of RBSG's control. This determination will also be made by RBSG's regulator and there may be many factors, including factors not directly related to RBSG, which could result in such a determination. Because of this inherent uncertainty, it will be difficult to predict when, if at all, the exercise of any U.K. bail-in power may occur which would result in a principal write off or conversion to equity. Accordingly, trading behavior may be affected by the threat of bail-in and, as a result, the Subordinated Notes are not necessarily expected to follow the trading behavior associated with other types of securities. Potential investors in the Subordinated Notes should consider the risk that a holder may lose all of its investment, including the principal amount plus any accrued interest, if the U.K. bail-in power is acted upon or that such Subordinated Notes may be converted into ordinary shares which ordinary shares may be of little value at the time of conversion.

Furthermore, there can be no assurance that the Basel Committee will not amend the Basel III Reforms. Further, the European Union and/or relevant authorities in the United Kingdom may implement the Basel III Reforms, including the provisions relating to terms which capital instruments are required to have, in a manner that is different from that which is currently envisaged or may impose more onerous requirements on U.K.-incorporated banks. Until fully implemented, RBSG cannot predict the precise effects of the changes that will result from the implementation of the Basel III Reforms on the pricing or the market value of the Subordinated Notes. In addition, further changes in law after the date hereof may affect the rights of holders of the Subordinated Notes as well as the market value of the Subordinated Notes.

Under the terms of the Subordinated Notes, you have agreed to be bound by the exercise of any U.K. bail-in power by the relevant U.K. resolution authority

By purchasing the Subordinated Notes, each holder (including each beneficial holder) of the Subordinated Notes acknowledges, agrees to be bound by and consents to the exercise of any U.K. bail-in power by the relevant U.K. resolution authority that may result in (i) the cancellation of all, or a portion, of the principal amount of, or interest on, the Subordinated Notes and/or (ii) the conversion of all, or a portion, of the principal amount of, or interest on, the Subordinated Notes into shares or other securities or other obligations of RBSG or another person, which U.K. bail-in power may be exercised by means of variation of the terms of the Subordinated Notes solely to give effect to the above. With respect to (i) and (ii) above, references to principal and interest shall include payments of principal and interest that have become due and payable (including principal that has become due and payable at the Maturity Date), but which have not been paid, prior to the exercise of any U.K. bail-in power. Each holder of the Subordinated Notes further acknowledges and agrees that the rights of the holders under the Subordinated Notes are subject to, and will be varied, if necessary, solely to give effect to, the exercise of any U.K. bail-in power by the relevant U.K. resolution authority expressed to implement such a cancellation or conversion.

Any U.K. bail-in power may be exercised in such a manner as to result in you and other holders of Subordinated Notes losing the value of all or a part of your investment in the Subordinated Notes or receiving a different security from the Subordinated Notes, which may be worth significantly less than the Subordinated Notes and which have significantly fewer protections than those typically afforded to debt securities. Moreover, the relevant U.K. resolution authority may exercise its authority to implement the U.K. bail-in power without providing any advance notice to the

holders of the Subordinated Notes. For more information, see “Description of the Subordinated Notes—Agreement with Respect to the Exercise of U.K. Bail-in Power”.

The circumstances under which the relevant U.K. resolution authority would exercise its proposed U.K. bail-in power are currently uncertain

The stated aim of the RRD is to provide supervisory authorities, including the relevant U.K. resolution authority, with common tools and powers to address banking crises pre-emptively in order to safeguard financial

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stability and minimize taxpayers' exposure to losses. However, as the RRD is still in draft form and will be subject to implementing measures in the United Kingdom, there is considerable uncertainty regarding the specific factors beyond the goals of addressing banking crises pre-emptively and minimizing taxpayers' exposure to losses (for example, by writing down relevant capital instruments before the injection of public funds into a financial institution) which the relevant U.K. resolution authority would consider in deciding whether to exercise the U.K. bail-in power with respect to the relevant financial institution and/or securities, such as the Subordinated Notes, issued by that institution. While the Banking Reform Bill provides some guidance as to how and when the bail-in tool may be utilized by U.K. resolution authorities, it is still in draft form and may be subject to change. In announcing the introduction of the bail-in option through the Banking Reform Bill, the U.K. Government expressed that it was confident that such powers could be introduced without the risk of having to adapt to a radically different regime when the RRD is implemented, given the legislative progress of the RRD. However, the RRD is still in draft form and changes may be made to the expected powers, which may require amendments to the bail-in option proposed to be inserted in the Banking Act 2009. Therefore, it is not yet possible to assess the full impact of the draft RRD on the Group and on the holders of the Subordinated Notes.

Moreover, as the final criteria that the relevant U.K. resolution authority would consider in exercising any U.K. bail-in power may provide it with discretion, holders of the Subordinated Notes may not be able to refer to publicly available criteria in order to anticipate a potential exercise of any such U.K. bail-in power.

Because the RRD and the Banking Reform Bill are currently in draft form, there is considerable uncertainty regarding the rights that holders of the Subordinated Notes may have to challenge the exercise of any U.K. bail-in power by the relevant U.K. resolution authority, and, when the final rules are implemented in the United Kingdom, your rights may be limited

As the draft RRD and Banking Reform Bill are subject to change, there is considerable uncertainty as to the extent, if any, that due process rights or procedures will be provided to holders of securities (including the Subordinated Notes) subject to the U.K. bail-in power and to the broader resolution powers of the relevant U.K. resolution authority when the final rules are implemented in the United Kingdom. As a result, holders of the Subordinated Notes may have limited rights to challenge any decision of the relevant U.K. resolution authority to exercise its U.K. bail-in power or to have that decision reviewed by a judicial or administrative process or otherwise. In addition, rights to compensation, if any, may be severely limited.

The Subordinated Notes may be redeemed prior to maturity if certain adverse tax or regulatory disqualification events occur

RBSG may, subject to certain conditions, opt to redeem all, but not some only, of the Subordinated Notes at their principal amount together with accrued but unpaid interest:

- (i) in the event that it is obliged to pay additional amounts in respect of United Kingdom withholding tax, or
- (ii) upon the occurrence of certain other changes in the treatment of the relevant Notes for tax purposes as described in "Description of the Subordinated Notes—Redemption—Tax Redemption".

If at any time a Capital Disqualification Event (as defined below) occurs and is continuing in relation to any of the Subordinated Notes, RBSG may, subject to certain conditions, redeem all, but not some only, of the Subordinated Notes at their principal amount together with accrued but unpaid interest.

A "Capital Disqualification Event" shall be deemed to have occurred if, as a result of any amendment to, or change in, the Capital Regulations (or official interpretation thereof) which are in effect at the Issue Date, the Subordinated Notes

are fully excluded from Tier 2 capital (as defined in the Capital Regulations) of RBSG and/or the Regulatory Group.

“Capital Regulations” mean, at any time, the regulations, requirements, guidelines and policies relating to capital adequacy of the PRA or of the European Parliament or of the Council of the European Union then in effect in the United Kingdom.

If the Subordinated Notes are to be so redeemed, there can be no assurance that holders of the Subordinated Notes will be able to reinvest the amounts received upon redemption at a rate that will provide the same rate of return as their investment in the Subordinated Notes.

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The Subordinated Notes contain limited Defaults and Events of Default, and the remedies available thereunder are limited

In addition to Events of Default, the Subordinated Notes contain “Defaults”, being the failure to pay principal or interest on the Subordinated Notes when it otherwise becomes due and payable (following the expiration of a specified grace period). If a Default occurs and is continuing with respect to the Subordinated Notes, the Trustee may commence a proceeding in Scotland (but not elsewhere) for our winding up and/or prove in our winding up, provided that the Trustee may not, upon the occurrence of a Default, declare the principal amount of any outstanding Subordinated Notes due and payable. While holders of the Subordinated Notes will similarly not be able to accelerate a repayment of the principal amount of the Subordinated Notes upon the occurrence of a Default, such holders shall have the right to sue for any payments that are due but unpaid.

As described in “Description of the Subordinated Notes—Events of Default and Defaults; Limitation of Remedies”, the Subordinated Notes contain limited Events of Default and remedies. If an order is made for our winding up which is not successfully appealed within 30 days or upon a valid adoption by our shareholders of an effective resolution for our winding up (in each case other than under or in connection with a scheme of amalgamation or reconstruction not involving bankruptcy or insolvency), an Event of Default will occur, but on the occurrence of such an Event of Default holders of the Subordinated Notes have only limited enforcement remedies. If such an Event of Default with respect to the Subordinated Notes occurs and is continuing, the Trustee or the holders of at least 25% in aggregate principal amount of the outstanding Subordinated Notes may declare the principal amount of, and any accrued but unpaid interest on, the Subordinated Notes to be due and payable immediately.

Prior to the occurrence of an Event of Default, the Subordinated Notes are subject to bail-in in the event the U.K. bail-in power is exercised. As a result, during such time as the Trustee is seeking to cause our winding up, your claims in such winding up could still be reduced to zero.

There is no limit on the amount or type of further securities or indebtedness that RBSG may issue, incur or guarantee

There is no restriction on the amount of securities or other liabilities that RBSG may issue, incur or guarantee and which rank senior to, or pari passu with, the Subordinated Notes. The issue or guaranteeing of any such securities or the incurrence of any such other liabilities may reduce the amount (if any) recoverable by holders of the Subordinated Notes on a winding up of RBSG and may limit RBSG’s ability to meet its obligations under the Subordinated Notes. In addition, the Subordinated Notes do not contain any restriction on RBSG’s ability to issue securities that may have preferential rights to the Subordinated Notes or securities with similar or different provisions.

The Subordinated Notes may not be a suitable investment for all investors

Each potential investor of the Subordinated Notes must determine the suitability (either alone or with the help of a financial adviser) of that investment in light of its own circumstances. In particular, each potential investor should:

- (i) have sufficient knowledge and experience to make a meaningful evaluation of the Subordinated Notes, the merits and risks of investing in the Subordinated Notes and the information contained or incorporated by reference in this prospectus supplement or any applicable supplement to this prospectus supplement;
- (ii) have access to, and knowledge of, appropriate analytical tools to evaluate, in the context of its particular financial situation, an investment in the Subordinated Notes and the impact such investment will have on its overall investment portfolio;

- (iii) have sufficient financial resources and liquidity to bear all of the risks of an investment in the Subordinated Notes, including where the currency for principal or interest payments, i.e., U.S. dollars, is different from the currency in which such potential investor's financial activities are principally denominated;
- (iv) understand thoroughly the terms of the Subordinated Notes, such as the provisions regarding the U.K. bail-in power, and be familiar with the behavior of any relevant indices and financial markets, including the possibility

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that the Subordinated Notes may become subject to write down or conversion if the U.K. bail-in power is exercised; and

(v) be able to evaluate possible scenarios for economic, interest rate and other factors that may affect its investment and its ability to bear the applicable risks.

A potential investor should not invest in the Subordinated Notes unless they have the knowledge and expertise (either alone or with a financial advisor) to evaluate how the Subordinated Notes will perform under changing conditions, the resulting effects on the likelihood of and the value of the Subordinated Notes, and the impact this investment will have on the potential investor's overall investment portfolio. Prior to making an investment decision, potential investors should consider carefully, in light of their own financial circumstances and investment objectives, all the information contained in this prospectus supplement and the base prospectus and incorporated by reference herein and therein.

There is no established trading market for the Subordinated Notes and one may not develop

The Subordinated Notes may have no established trading market when issued, and one may never develop. If a market does develop, it may not be liquid. Therefore, investors may not be able to sell their Subordinated Notes easily or at prices that will provide them with a yield comparable to similar investments that have a developed secondary market. This is particularly the case for notes that are especially sensitive to interest rates, currency or market risks, are designed for specific investment objectives or strategies, are subject to bail-in, or have been structured to meet the investment requirements of limited categories of investors. These types of notes would generally have a more limited secondary market and more price volatility than conventional debt securities. Illiquidity may have a material adverse effect on the market value of the Subordinated Notes.

A downgrade, suspension or withdrawal of the rating assigned by any rating agency to the Subordinated Notes could cause the liquidity or market value of the Subordinated Notes to decline

Upon issuance, the Subordinated Notes will be rated by U.S. nationally recognized statistical ratings organizations and may in the future be rated by additional rating agencies. Any rating initially assigned to the Subordinated Notes may be lowered or withdrawn entirely by a rating agency if, in that rating agency's judgment, circumstances relating to the basis of the rating, such as adverse changes to our business, so warrant. Any lowering or withdrawal of a rating by a rating agency could reduce the liquidity or market value of the Subordinated Notes.

The market value of the Subordinated Notes may be influenced by unpredictable factors

Certain factors, many of which are beyond RBSG's control, will influence the value of the Subordinated Notes and the price, if any, at which securities dealers may be willing to purchase or sell the Subordinated Notes in the secondary market, including:

- the creditworthiness of RBSG from time to time;
- supply and demand for the Subordinated Notes;
- economic, financial, political or regulatory events or judicial decisions that affect RBSG or the financial markets generally, including the introduction of any financial transactions tax; and
- the trading price of our Ordinary Shares and/or ADSs.

Accordingly, if a holder sells its Subordinated Notes in the secondary market, it may not be able to obtain a price equal to the principal amount of the Subordinated Notes or a price equal to the price that it paid for the Subordinated Notes.

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RECENT DEVELOPMENTS

Q3 2013 Interim Report

Please refer to our Q3 2013 Interim Report, which contains recent developments, including in relation to (i) certain actions the Group intends to take to strengthen its capital position and with respect to its ongoing strategic review and (ii) the Group's ongoing litigation, investigation and reviews, and which is incorporated by reference herein.

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USE OF PROCEEDS

The net proceeds from the issue of the Subordinated Notes are expected to amount to U.S.\$1,973,560,000 after deduction of the underwriting commission and the other expenses incurred in connection with the issue of the Subordinated Notes. We intend to use the net proceeds of the offering for general corporate purposes.

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CAPITALIZATION OF THE GROUP

The following table shows the Group's issued and fully paid share capital, owners' equity and indebtedness on an unaudited consolidated basis in accordance with International Financial Reporting Standards as at September 30, 2013.

	As at September 30, 2013	
	Actual	As Adjusted(1)
	£ million	£ million
Share capital – allotted, called up and fully paid		
Ordinary shares of £1.00	6,186	6,186
B shares of £0.01	510	510
Dividend access share of £0.01(2)	-	-
Non-cumulative preference shares of U.S.\$0.01	1	1
Non-cumulative preference shares of €0.01(3)	-	-
Non-cumulative preference shares of £1.00(4)	-	-
	6,697	6,697
Retained income and other reserves	60,971	60,971
Owners' equity	67,668	67,668
Group indebtedness		
Subordinated liabilities	23,720	24,956
Debt securities in issue	71,781	71,781
Total indebtedness	95,501	96,737
Total capitalization and indebtedness	163,169	164,405

(1) The 'As adjusted' column reflects the effects of the issue of the Subordinated Notes offered hereby. Amounts shown have been converted from dollars to sterling at a rate of \$1.618 = £1.00, the rate used to translate assets and liabilities as at September 30, 2013. We make no representation that amounts have been or could have been or could in the future be converted into dollars at that rate or any other rate.

(2) As at September 30, 2013, there was one Dividend access share of £0.01 outstanding.

(3) As at September 30, 2013, there were 2,044,418 Non-cumulative preference shares of €0.01 outstanding, representing €20,444 (£14,052, converted from euros to sterling at a rate of £1.4549, the rate used to translate assets and liabilities as at the date of issue). We make no representation that amounts have been or could have been or could in the future be converted into sterling at that rate or any other rate.

(4) As at September 30, 2013, there were 54,442 Non-cumulative preference shares of £1.00 outstanding, representing £54,442.

Under IFRS, certain preference shares are classified as debt and are included in subordinated liabilities in the table above.

Since September 30, 2013, issuances of debt securities totaled £2.1 billion (gross). Buybacks and maturities were £3.9 billion since September 30, 2013, thereby exceeding issuance by £1.8 billion.

Other than as disclosed above, the information contained in the table above has not changed materially since September 30, 2013.

The Group will continue to assess market conditions with a view to conducting debt offerings and liability management transactions from time to time.

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RATIO OF EARNINGS TO FIXED CHARGES

	Nine-Months Ended September 30, 2013(3)	2012	2011	2010	2009	2008
Ratio of earnings to combined fixed charges and preference share dividends(1)(2)						
– including interest on deposits	1.09	0.29	0.87	0.97	0.73	0.02
– excluding interest on deposits	1.39	(2.94)	(0.17)	0.67	(0.44)	(8.06)
Ratio of earnings to fixed charges only(1)(2)						
– including interest on deposits	1.16	0.30	0.87	0.98	0.78	0.02
– excluding interest on deposits	1.84	(3.71)	(0.17)	0.78	(0.66)	(10.06)

(1) For this purpose, earnings consist of income before tax and non-controlling interests, plus fixed charges less the unremitted income of associated undertakings (share of profits less dividends received). Fixed charges consist of total interest expense, including or excluding interest on deposits and debt securities in issue, as appropriate, and the proportion of rental expense deemed representative of the interest factor (one third of total rental expenses).

(2) The earnings for the years ended December 31, 2012, 2011, 2010, 2009 and 2008 were inadequate to cover total fixed charges and preference share dividends. The coverage deficiency for total fixed charges and preference share dividends for the years ended December 31, 2012, 2011, 2010, 2009 and 2008 were £5,453 million (\$8,683 million), £1,190 million (\$1,916 million), £278 million (\$429 million), £3,951 million (\$6,206 million) and £27,051 million (\$49,839 million), respectively. The coverage deficiency for fixed charges only for the years ended December 31, 2012, 2011, 2010, 2009 and 2008 were £5,165 million (\$8,225 million), £1,190 million (\$1,916 million), £154 million (\$237 million), £3,016 million (\$4,737 million) and £26,455 million (\$48,741 million), respectively. Dollar amounts have been converted from sterling at the following rates which are the average of the Noon Buying Rates on the last U.S. business day of each month during the relevant year: (i) £1 = \$1.5924 for the year ended December 31, 2012; (ii) £1 = \$1.6105 for the year ended December 31, 2011; (iii) £1 = \$1.5415 for the year ended December 31, 2010; (iv) £1 = \$1.5707 for the year ended December 31, 2009; and (v) £1 = \$1.8424 for the year ended December 31, 2008.

(3) Based on unaudited numbers.

DESCRIPTION OF THE SUBORDINATED NOTES

The following is a summary of certain terms of the Subordinated Notes. It supplements the description of the general terms of the debt securities of any series we may issue contained in the accompanying prospectus under the heading “Description of Debt Securities”. If there is any inconsistency between the following summary and the description in the accompanying prospectus, the following summary governs.

The Subordinated Notes will be issued in an aggregate principal amount of \$2,000,000,000 and will mature on December 19, 2023. The Subordinated Notes will bear interest from (and including) the Issue Date at a rate of 6.00% per annum. Interest will be payable semi-annually in arrears on June 19 and December 19 of each year, commencing on June 19, 2014. The regular record dates for the Subordinated Notes will be June 5 and December 5 of each year immediately preceding the Interest Payment Dates on June 19 and December 19, respectively.

If any scheduled Interest Payment Date is not a Business Day, we will pay interest on the next Business Day, but interest on that payment will not accrue during the period from and after the scheduled Interest Payment Date. If the scheduled Maturity Date or date of redemption (in the circumstances described in “—Redemption” below) or repayment is not a Business Day, we may pay interest and principal on the next succeeding Business Day, but interest on that payment will not accrue during the period from and after the scheduled Maturity Date or date of redemption or repayment.

In this description of the Subordinated Notes, the following expressions have the following meanings:

“Business Day” means a day on which commercial banks and foreign exchange markets settle payments and are open for general business (including dealing in foreign exchange and foreign currency deposits) in New York City and London.

“Capital Disqualification Event” shall be deemed to have occurred if, as a result of any amendment to, or change in, the Capital Regulations (or official interpretation thereof) which are in effect at the Issue Date, the Subordinated Notes are fully excluded from Tier 2 capital (as defined in the Capital Regulations) of RBSG and/or the Regulatory Group.

“Capital Instruments Regulations” means any regulatory capital rules, regulations or standards which are in the future applicable to us (on a solo or consolidated basis and including any implementation thereof or supplement thereto by the PRA from time to time) and which lay down the requirements to be fulfilled by financial instruments for inclusion in our regulatory capital (on a solo or consolidated basis) as required by (i) the CRD IV Regulation and/or (ii) the CRD IV Directive, including (for the avoidance of doubt) any regulatory technical standards issued by the European Banking Authority.

“Capital Regulations” means, at any time, the regulations, requirements, guidelines and policies relating to capital adequacy of the PRA or of the European Parliament or of the Council of the European Union then in effect in the United Kingdom.

“CRD IV” means, taken together, (i) the CRD IV Directive, (ii) the CRD IV Regulation and (iii) the Capital Instruments Regulations.

“CRD IV Directive” means Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC, and any successor directive.

“CRD IV Regulation” means Regulation (EU) No. 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms amending Regulation (EU) No 648/2012, and any successor regulation.

“Interest Payment Date” means June 19 and December 19 in each year, commencing June 19, 2014.

“Issue Date” means December 19, 2013.

“Maturity Date” means December 19, 2023.

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“PRA” means the Prudential Regulation Authority or such other governmental authority in the United Kingdom (or, if the Issuer becomes domiciled in a jurisdiction other than the United Kingdom, in such other jurisdiction) having primary supervisory authority with respect to the prudential regulation of the Issuer’s business.

“Regulatory Group” means the Issuer, its subsidiary undertakings, participations, participating interests and any subsidiary undertakings, participations or participating interests held (directly or indirectly) by any of its subsidiary undertakings from time to time and any other undertakings from time to time consolidated with it for regulatory purposes, in each case in accordance with the rules and guidance of the PRA then in effect.

Redemption

Unless previously redeemed or purchased and cancelled, the Subordinated Notes will be redeemed on the Maturity Date at 100% of their principal amount, together with any accrued and unpaid interest to (but excluding) the Maturity Date.

Tax Redemption

We may redeem the Subordinated Notes at any time in whole but not in part upon not less than 30 calendar days’ nor more than 60 calendar days’ notice to the holders of Subordinated Notes in the event of certain changes in the tax laws of the United Kingdom and certain other limited circumstances, provided that, in our opinion, the circumstance that entitles us to exercise such right of redemption was not reasonably foreseeable to us at the Issue Date and provided that upon CRD IV taking effect in the United Kingdom, such right of redemption shall only apply if, when and to the extent not prohibited by CRD IV. In the event of such redemption, the redemption price of the Subordinated Notes will be 100% of their principal amount together with any accrued but unpaid payments of interest to the date of redemption. Any such redemption will be subject to a requirement to give notice to or obtain the consent of the PRA, as set forth below under “—Prudential Regulation Authority”.

If we elect to redeem the Subordinated Notes, they will cease to accrue interest from the redemption date, unless we fail to pay the redemption price on the payment date. The circumstances in which we may redeem the Subordinated Notes and the applicable procedures are described further in the accompanying prospectus under “Description of Debt Securities—Redemption”.

Redemption due to a Capital Disqualification Event

We may redeem the Subordinated Notes at any time in whole but not in part upon not less than 30 calendar days’ nor more than 60 calendar days’ notice to the holders of Subordinated Notes if, at any time immediately prior to the giving of the notice referred to above, a Capital Disqualification Event has occurred and is continuing, provided that, in our opinion, the circumstance that entitles us to exercise such right of redemption was not reasonably foreseeable to us at the Issue Date and provided that upon CRD IV taking effect in the United Kingdom, such right of redemption shall only apply if, when and to the extent not prohibited by CRD IV. In the event of such redemption, the redemption price of the Subordinated Notes will be 100% of their principal amount together with any accrued and unpaid payments of interest to the date of redemption. Any such redemption will be subject to a requirement to give notice to or obtain the consent of the PRA, as set forth below under “—Prudential Regulation Authority”.

If we elect to redeem the Subordinated Notes, they will cease to accrue interest from the redemption date, unless we fail to pay the redemption price on the payment date.

Repurchase

We may at any time and from time to time purchase Subordinated Notes in the open market or by tender or by private agreement in any manner and at any price or at differing prices, provided that, upon CRD IV taking effect in the United Kingdom, purchases are only permitted if, when and to the extent not prohibited by CRD IV. Subordinated Notes purchased or otherwise acquired by us may be (i) held, (ii) resold or (iii) at our sole discretion, surrendered to the Trustee for cancellation (in which case all Subordinated Notes so surrendered will forthwith be cancelled in accordance with applicable law and thereafter may not be re-issued or resold). Any such purchases will be subject to a requirement to give notice to or obtain the consent of the PRA, as set forth below under “—Prudential Regulation Authority”.

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Prudential Regulation Authority

As of the date hereof, we may only redeem or repurchase the Subordinated Notes prior to the Maturity Date as provided above or legally release ourselves from obligations (as described under “—Discharge” below), provided that (except to the extent that the PRA no longer so requires) (i) we have notified the PRA of our intention to do so at least one month (or such other, longer or shorter period, as the PRA may then require or accept) before we become committed to the proposed redemption, repayment or discharge, and no objection thereto has been raised by the PRA or (if required) the PRA has provided its consent thereto and (ii) when giving notice of redemption, repayment or discharge, we shall provide details in order to demonstrate that following such redemption, repayment or discharge, we will (A) be able to meet our capital resources requirements and (B) have sufficient financial resources to meet the PRA’s overall financial adequacy rule, each as provided in the Capital Regulations. In addition (i) as of the date hereof, we may only redeem the Subordinated Notes as set out in “—Tax Redemption” and “—Redemption due to a Capital Disqualification Event” above if we demonstrate to the PRA that the circumstance giving rise to our right to redeem the Subordinated Notes was not reasonably foreseeable at the Issue Date and (ii) upon CRD IV taking effect in the United Kingdom, it is our expectation that we may only redeem the Subordinated Notes as set out in “—Tax Redemption” and “—Redemption due to a Capital Disqualification Event” above if we demonstrate to the PRA that the circumstance giving rise to our right to redeem the Subordinated Notes was not reasonably foreseeable at the Issue Date and, in the case of a redemption as set out in “—Tax Redemption”, that the change in the applicable tax treatment relating to the Subordinated Notes is material.

Agreement with Respect to the Exercise of U.K. Bail-in Power

By purchasing the Subordinated Notes, each holder (including each beneficial holder) of the Subordinated Notes acknowledges, agrees to be bound by and consents to the exercise of any U.K. bail-in power (as defined below) by the relevant U.K. resolution authority that may result in (i) the cancellation of all, or a portion, of the principal amount of, or interest on, the Subordinated Notes and/or (ii) the conversion of all, or a portion, of the principal amount of, or interest on, the Subordinated Notes into shares or other securities or other obligations of RBSG or another person, which U.K. bail-in power may be exercised by means of variation of the terms of the Subordinated Notes solely to give effect to the above. With respect to (i) and (ii) above, references to principal and interest shall include payments of principal and interest that have become due and payable (including principal that has become due and payable at the Maturity Date), but which have not been paid, prior to the exercise of any U.K. bail-in power. Each holder of the Subordinated Notes further acknowledges and agrees that the rights of the holders under the Subordinated Notes are subject to, and will be varied, if necessary, solely to give effect to, the exercise of any U.K. bail-in power by the relevant U.K. resolution authority expressed to implement such a cancellation or conversion.

For these purposes, a “U.K. bail-in power” is any write-down and/or conversion power existing from time to time under any laws, regulations, rules or requirements relating to the resolution of banks, banking group companies, credit institutions and/or investment firms incorporated in the United Kingdom in effect and applicable in the United Kingdom to us or other members of the Group, including but not limited to any such laws, regulations, rules or requirements which are implemented, adopted or enacted within the context of a European Union directive or regulation of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms and/or within the context of a U.K. resolution regime by way of amendment to the Banking Act 2009 or otherwise, pursuant to which obligations of a bank, banking group company, credit institution or investment firm or any of its affiliates can be reduced, cancelled, transferred and/or converted into shares or other securities or obligations of the obligor or any other person (and a reference to the “relevant U.K. resolution authority” is to any authority with the ability to exercise a U.K. bail-in power).

According to the principles proposed in the RRD and the amendments to the Banking Act 2009 by way of the Banking Reform Bill, we expect that the relevant U.K. resolution authority would exercise its U.K. bail-in powers in

respect of the Subordinated Notes having regard to the hierarchy of creditor claims (with the exception of excluded liabilities) and that the holders of the Subordinated Notes would be treated pari passu with all other pari passu claims at that time being subjected to the exercise of the U.K. bail-in powers.

No repayment of the principal amount of the Subordinated Notes or payment of interest on the Subordinated Notes shall become due and payable after the exercise of any U.K. bail-in power by the relevant U.K. resolution authority unless, at the time that such repayment or payment, respectively, is scheduled to become due, such

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repayment or payment would be permitted to be made by us under the laws and regulations of the United Kingdom and the European Union applicable to us or other members of the Group.

See also “Risk Factors—Under the terms of the Subordinated Notes, you have agreed to be bound by the exercise of any U.K. bail-in power by the relevant U.K. resolution authority.”

By purchasing the Subordinated Notes, each holder (including each beneficial holder) of the Subordinated Notes: (i) acknowledges and agrees that the exercise of the U.K. bail-in power by the relevant U.K. resolution authority with respect to the Subordinated Notes shall not give rise to a Default or Event of Default for purposes of Section 315(b) (Notice of Default) and Section 315(c) (Duties of the Trustee in Case of Default) of the Trust Indenture Act; and (ii) to the extent permitted by the Trust Indenture Act, waives any and all claims against the Trustee for, agrees not to initiate a suit against the Trustee in respect of, and agrees that the Trustee shall not be liable for, any action that the Trustee takes, or abstains from taking, in either case in accordance with the exercise of the U.K. bail-in power by the relevant U.K. resolution authority with respect to the Subordinated Notes.

By purchasing the Subordinated Notes, each holder (including each beneficial holder) shall be deemed to have (i) consented to the exercise of any U.K. bail-in power as it may be imposed without any prior notice by the relevant U.K. resolution authority of its decision to exercise such power with respect to the Subordinated Notes and (ii) authorized, directed and requested DTC and any direct participant in DTC or other intermediary through which it holds such Subordinated Notes to take any and all necessary action, if required, to implement the exercise of any U.K. bail-in power with respect to the Subordinated Notes as it may be imposed, without any further action or direction on the part of such holder.

Upon the exercise of the U.K. bail-in power by the relevant U.K. resolution authority with respect to the Subordinated Notes, we shall provide a written notice to DTC as soon as practicable regarding such exercise of the U.K. bail-in power for purposes of notifying holders of such occurrence. We shall also deliver a copy of such notice to the Trustee for information purposes.

Events of Default and Defaults; Limitation of Remedies

An “Event of Default” with respect to the Subordinated Notes shall result if:

- a court of competent jurisdiction makes an order for our winding up which is not successfully appealed within 30 days; or
- an effective shareholders’ resolution is validly adopted for our winding up,

in each case other than under or in connection with a scheme of amalgamation or reconstruction not involving a bankruptcy or insolvency.

There are no other Events of Default under the Subordinated Notes. If an Event of Default with respect to the Subordinated Notes occurs and is continuing, the Trustee or the holder or holders of at least 25% in aggregate principal amount of the outstanding Subordinated Notes may declare the principal amount of, and any accrued but unpaid payments on the Subordinated Notes to be due and payable immediately in accordance with the terms of the Subordinated Indenture. However, after this declaration but before the Trustee obtains a judgment or decree for payment of money due, the holder or holders of a majority in aggregate principal amount of the outstanding Subordinated Notes may rescind the declaration of acceleration and its consequences, but only if all Events of Default have been remedied and all payments due, other than those due as a result of acceleration, have been made.

Defaults

In addition to Events of Default, the Subordinated Indenture also separately provides for Defaults. A “Default” with respect to the Subordinated Notes shall result if:

- any installment of interest is not paid on or before its Interest Payment Date and such failure continues for 14 days;
or
- all or any part of the principal amount of the Subordinated Notes is not paid when it otherwise becomes due and payable, whether upon redemption or otherwise and such failure continues for seven days.

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If a Default occurs and is continuing, the Trustee may commence a proceeding in Scotland (but not elsewhere) for our winding up, but the Trustee may not declare the principal amount of the outstanding Subordinated Notes due and payable.

However, failure to make any payment on the Subordinated Notes shall not be a Default if it is withheld or refused, upon independent counsel's advice delivered to the Trustee, in order to comply with any applicable fiscal or other law or regulation or order of any court of competent jurisdiction. In such case, the Trustee may require us to take any action which, upon independent counsel's advice delivered to the Trustee, is appropriate and reasonable in the circumstances (including proceedings for a court declaration), in which case we shall immediately take and expeditiously proceed with the action and shall be bound by any final resolution resulting therefrom. If any such action results in a determination that the relevant payment can be made without violating any applicable law, regulation or order then the payment shall become due and payable on the expiration of the applicable 14-day or seven-day period after the Trustee gives written notice to us informing us of such determination.

Upon the occurrence of any Event of Default or Default, we shall give prompt written notice to the Trustee. In accordance with the Subordinated Indenture, the Trustee may proceed to protect and enforce its rights and the rights of the holders of the Subordinated Notes whether in connection with any breach by us of our obligations under the Subordinated Notes, the Subordinated Indenture or otherwise, including by judicial proceedings, provided that we shall not, as a result of any such action by the Trustee, be required to pay any amount representing or measured by reference to principal or interest on the Subordinated Notes prior to any date on which the principal of, or any interest on, the Subordinated Notes would have otherwise been payable.

Other than the limited remedies specified above, no remedy against us shall be available to the Trustee or the holders of the Subordinated Notes whether for the recovery of amounts owing in respect of such Subordinated Notes or under the Subordinated Indenture or in respect of any breach by us of our obligations under the Subordinated Indenture or in respect of the Subordinated Notes, except that the Trustee and the holders shall have such rights and powers as they are entitled to have under the Trust Indenture Act of 1939 (the "Trust Indenture Act"), including the Trustee's prior lien on any amounts collected following a Default or Event of Default for payment of the Trustee's fees and expenses, and provided that any payments on the Subordinated Notes are subject to the subordination provisions set forth in the Subordinated Indenture.

Assumption

Subject to applicable law and regulation, any of our wholly-owned subsidiaries may assume our obligations under the Subordinated Notes without the consent of any holder, provided that certain conditions are satisfied, including that under the Subordinated Indenture we unconditionally guarantee the obligations of the subsidiary under the Subordinated Notes and that we obtain the prior consent of, or give notification to (and no objection is raised by), the PRA. If we do, all of our direct obligations under the Subordinated Notes and the Subordinated Indenture shall immediately be discharged. Any Additional Amounts under the Subordinated Notes will be payable in respect of taxes imposed by the jurisdiction in which the assuming subsidiary is organized or is a tax resident, subject to exceptions equivalent to those that apply to any obligation to pay Additional Amounts in respect of taxes imposed by any U.K. taxing jurisdiction, rather than taxes imposed by any U.K. taxing jurisdiction. The subsidiary that assumes our obligations will also be entitled to redeem the Subordinated Notes in the circumstances described in "—Redemption" above with respect to any change or amendment to, or change in the application or official interpretation of, the laws or regulations (including any treaty) of the assuming subsidiary's jurisdiction of organization, provided that upon CRD IV taking effect in the United Kingdom, such right of redemption shall only apply if, when and to the extent not prohibited by CRD IV. Any such redemption will be subject to a requirement to give notice to or obtain the consent of the PRA, as set forth above under "Redemption—Prudential Regulation Authority".

For U.S. federal income tax purposes, an assumption of our obligations under the Subordinated Notes might be deemed to be an exchange of the Subordinated Notes for new subordinated notes by each beneficial owner, resulting in recognition of a taxable gain or loss for those purposes and possibly certain other adverse tax consequences. You should consult your tax advisor regarding the U.S. federal, state and local income tax consequences of an assumption.

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General

The Subordinated Notes will constitute our direct, unconditional, unsecured and subordinated obligations ranking *pari passu* without any preference among themselves and ranking junior in right of payment to the claims of any existing and future unsecured and unsubordinated indebtedness. In a winding up or in the event that an administrator has been appointed in respect of us and notice has been given that it intends to declare and distribute a dividend, all payments on the Subordinated Notes will be subordinated to, and subject in right of payment to the prior payment in full of, all claims of all of our creditors other than claims in respect of any liability that is, or is expressed to be, subordinated to the claims of all or any of our creditors, whether only in the event of a winding up or otherwise. The ranking of our obligations shall be set out in the manner provided in the Subordinated Indenture. In addition, because we are a holding company, our rights to participate in the assets of any subsidiary if it is liquidated will be subject to the prior claims of its creditors, including in the case of bank subsidiaries, their depositors, except to the extent that we may be a creditor with recognized claims against the subsidiary.

The Subordinated Notes will constitute a separate series of subordinated debt securities issued under the Subordinated Indenture. Book-entry interests in the Subordinated Notes will be issued in minimum denominations of \$2,000 and in integral multiples of \$1,000 in excess thereof. Interest on the Subordinated Notes will be computed on the basis of a 360-day year of twelve 30-day months.

The principal corporate trust office of the Trustee in London, United Kingdom, is designated as the principal paying agent. We may at any time designate additional paying agents or rescind the designation of paying agents or approve a change in the office through which any paying agent acts.

We will issue the Subordinated Notes in fully registered form. The Subordinated Notes will be represented by global securities registered in the name of a nominee of DTC. You will hold beneficial interest in the Subordinated Notes through the DTC and its participants. The Underwriters expect to deliver the Subordinated Notes through the facilities of the DTC on December 19, 2013. For a more detailed summary of the form of the Subordinated Notes and settlement and clearance arrangements, you should read “Description of Debt Securities—Form of Debt Securities; Book-Entry System” in the accompanying prospectus. Indirect holders trading their beneficial interests in the Subordinated Notes through the DTC must trade in the DTC’s same-day funds settlement system and pay in immediately available funds. Secondary market trading through Euroclear and Clearstream will occur in the ordinary way following the applicable rules and operating procedures of Euroclear and Clearstream Banking.

Definitive debt securities will only be issued in limited circumstances described under “Description of Debt Securities—Form of Debt Securities; Book-Entry System—Issuance of Definitive Securities” in the accompanying prospectus.

Payment of principal of and interest on the Subordinated Notes, so long as the Subordinated Notes are represented by global securities, will be made in immediately available funds. Beneficial interests in the global securities will trade in the same-day funds settlement system of the DTC, and secondary market trading activity in such interests will therefore settle in same-day funds.

We may, from time to time, without the consent of the holders of the Subordinated Notes, issue additional notes under the Subordinated Indenture having the same ranking and same interest rate, maturity date, redemption terms and other terms as the Subordinated Notes described in this prospectus supplement except for the price to the public and issue date. Any such additional notes, together with the Subordinated Notes offered by this prospectus supplement, may constitute a single series of securities under the Subordinated Indenture, provided that if such additional notes have the same CUSIP, ISIN or other identifying number as the outstanding Subordinated Notes, such additional notes must be fungible with the Subordinated Notes for U.S. federal income tax purposes. There is no limitation on the amount of

notes or other debt securities that we may issue under the Subordinated Indenture.

Payment of Additional Amounts

The government of the United Kingdom may require us to withhold or deduct amounts from payments of principal or interest on the Subordinated Notes, for taxes or other governmental charges. If such a withholding or deduction is required, we may be required, subject to certain exceptions, to pay additional amounts such that the net amount paid to holders of the Subordinated Notes, after such deduction or withholding, equals the amount that would have been payable had no such withholding or deduction been required. For more information on additional

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amounts and the situations in which we must pay additional amounts, see “Description of Debt Securities—Additional Amounts” in the accompanying prospectus.

Waiver of Right to Set-Off

By accepting a Subordinated Note, each holder will be deemed to have waived any right of set-off, counterclaim or combination of accounts with respect to such Subordinated Note or the Subordinated Indenture (or between our obligations under or in respect of any Subordinated Note and any liability owed by a holder) that they might otherwise have against us, whether before or during our winding up, liquidation or administration. Notwithstanding the above, if any such rights and claims of any such holder against us are discharged by set-off, such holder will immediately pay an amount equal to the amount of such discharge to us or, in the event of a winding up or administration, the liquidator or administrator (or other relevant insolvency official), as the case may be, on trust for senior creditors, and until such time as payment is made will hold a sum equal to such amount in trust for senior creditors, and accordingly such discharge shall be deemed not to have taken place.

Discharge

We can legally release ourselves from any payment or other obligations on the Subordinated Notes, except for various obligations described below, if the Subordinated Notes have become due and payable or will become due and payable at their stated maturity within one year or are to be called for redemption within one year and we deposit in trust for your benefit and the benefit of all other direct holders of the Subordinated Notes a combination of money and U.S. government or U.S. government agency notes or bonds that will generate enough cash to make interest, principal and any other payments on the Subordinated Notes on their various due dates; provided that, upon CRD IV taking effect in the United Kingdom, such right of discharge shall only apply if, when and to the extent not prohibited by CRD IV. Any such discharge will be subject to a requirement to give notice to or obtain the consent of the PRA, as set forth above under “Redemption—Prudential Regulation Authority”.

In addition, on the date of such deposit, we must not be in default. For purposes of this no-default test, a Default would include an Event of Default that has occurred and not been cured, as described under “Description of Debt Securities—Events of Default and Defaults; Limitation of Remedies—Subordinated Debt Securities Event of Default or Capital Securities Event of Default” in the accompanying prospectus. A Default for this purpose would also include any event that would be an Event of Default if the requirements for giving us default notice or our Default having to exist for a specific period of time were disregarded.

However, even if we take these actions, a number of our obligations under the Subordinated Indenture will remain.

Trustee; Direction of Trustee

The Trustee for the holders of the Subordinated Notes will be The Bank of New York Mellon, acting through its London Branch. See “—Events of Default and Defaults; Limitation of Remedies” above for a description of the Trustee’s procedures and remedies available in connection with an Event of Default or Default.

The Issuer’s obligations to indemnify the Trustee in accordance with Section 6.07 of the Base Subordinated Indenture, as amended by Section 3.23 of the First Supplemental Subordinated Indenture, shall survive the exercise of the U.K. bail-in power by the relevant U.K. resolution authority with respect to the Subordinated Notes.

By its acquisition of the Subordinated Notes, each holder of the Subordinated Notes acknowledges and agrees that, upon the exercise of any U.K. bail-in power by the relevant U.K. resolution authority, (a) the Trustee shall not be required to take any further directions from holders of the Subordinated Notes under Section 5.12 (Control by

Holders) of the Base Subordinated Indenture, which authorizes holders of a majority in aggregate outstanding principal amount of the Subordinated Notes to direct certain actions relating to the Subordinated Notes, and (b) none of the Base Subordinated Indenture, the First Supplemental Subordinated Indenture or the Third Supplemental Subordinated Indenture shall impose any duties upon the Trustee whatsoever with respect to the exercise of any U.K. bail-in power by the relevant U.K. resolution authority. Notwithstanding the foregoing, if, following the completion of the exercise of the U.K. bail-in power by the relevant U.K. resolution authority, the Subordinated Notes remain outstanding (for example, if the exercise of the U.K. bail-in power results in only a partial write-down of the principal of the Subordinated Notes), then the Trustee's duties under the Indenture shall remain applicable

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with respect to the Subordinated Notes following such completion to the extent that the Issuer and the Trustee shall agree pursuant to a supplemental indenture or an amendment to the Third Supplemental Subordinated Indenture.

In addition to the foregoing, the Trustee may decline to act or accept direction from holders unless it receives written direction from holders representing a majority in aggregate principal amount of the Subordinated Notes and security and/or indemnity satisfactory to the Trustee in its sole discretion. The Subordinated Indenture shall not be deemed to require the Trustee to take any action which may conflict with applicable law, or which may be unjustly prejudicial to the holders not taking part in the direction, or which would subject the Trustee to undue risk or for which it is not indemnified to its satisfaction in its sole discretion.

The Trustee makes no representations regarding, and shall not be liable with respect to, the information set forth in this prospectus supplement.

Subsequent Holders' Agreement

Holders of the Subordinated Notes that acquire the Subordinated Notes in the secondary market shall be deemed to acknowledge, agree to be bound by and consent to the same provisions specified herein to the same extent as the holders of the Subordinated Notes that acquire the Subordinated Notes upon their initial issuance, including, without limitation, with respect to the acknowledgement and agreement to be bound by and consent to the terms of the Subordinated Notes related to the U.K. bail-in power.

Governing Law

The Subordinated Notes and the Subordinated Indenture will be governed by and construed in accordance with the laws of the State of New York, except that, as the Subordinated Indenture specifies, the subordination provisions and the waiver of the right to set-off by the holders and by the Trustee acting on behalf of the holders with respect to the Subordinated Notes will be governed by and construed in accordance with the laws of Scotland.

Listing

We intend to apply to list the Subordinated Notes on the New York Stock Exchange in accordance with its rules.

U.K. AND U.S. FEDERAL TAX CONSEQUENCES

The following is a summary of material U.K. and U.S. federal income tax consequences of the ownership and disposition of the Subordinated Notes by a “U.S. holder” described below, that is not connected with us for relevant tax purposes, that holds the Subordinated Notes as capital assets and that purchases the Subordinated Notes in their initial offering at their “issue price”, which will be equal to the first price at which a substantial amount of the Subordinated Notes is sold for money to the public (not including bondhouses, brokers or similar persons or organizations acting in the capacity of underwriters, placement agents or wholesalers). For purposes of this discussion, a “U.S. holder” is a beneficial owner of a Subordinated Note that is for U.S. federal income tax purposes (i) a citizen or individual resident of the United States, (ii) a corporation, or other entity taxable as a corporation for U.S. federal income tax purposes, created or organized in or under the laws of the United States, any state thereof or the District of Columbia, or (iii) an estate or trust the income of which is subject to U.S. federal income taxation regardless of its source.

This discussion does not describe all of the tax consequences that may be relevant to U.S. holders in light of their particular circumstances, including alternative minimum tax and Medicare contribution tax consequences, as well as differing tax consequences that may apply to holders subject to special rules, such as:

- holders who are resident in the United Kingdom for U.K. tax purposes;
 - certain financial institutions;
 - insurance companies;
 - dealers in securities or foreign currencies;
- persons holding Subordinated Notes as part of a hedge or other integrated transaction;
- persons whose functional currency is not the U.S. dollar;
- partnerships or other entities classified as partnerships for U.S. federal income tax purposes; or
- persons carrying on a trade in the United Kingdom through a permanent establishment in the United Kingdom or carrying on a trade, profession or vocation in the United Kingdom through a branch or agency in the United Kingdom.

If a partnership holds a Subordinated Note, the U.S. federal income tax treatment of a partner generally will depend upon the status of the partner and the activities of the partnership. A partnership or partner of a partnership holding a Subordinated Note should consult its tax advisor.

The statements regarding U.K. and U.S. tax laws and practices set out below, including those regarding the U.K./U.S. double taxation convention relating to income and capital gains (the “Treaty”), are based on those laws, practices and conventions as of the date of this prospectus supplement, save where expressly stated to the contrary. They are subject to changes in those laws, practices and conventions, and any relevant judicial decision, which changes may have retroactive effect. This summary is not exhaustive of all possible tax considerations that may be relevant in the particular circumstances of each U.S. holder. In particular, this summary does not deal with the tax treatment of the Subordinated Notes following any exercise of U.K. bail-in power. You should satisfy yourself as to the tax consequences in your own particular circumstances of the acquisition, ownership and disposition of the Subordinated Notes.

United Kingdom

Payments. Interest that we pay on the Subordinated Notes will not be subject to withholding or deduction for or on account of U.K. tax, provided that the Subordinated Notes are and remain listed on the New York Stock Exchange or some other “recognised stock exchange” within the meaning of Section 1005 of the Income Tax Act 2007.

In all other cases, U.K. income tax must generally be withheld at the basic rate (currently 20%), unless one of certain exceptions relating to the status of the holder applies. In particular, certain U.S. holders will be entitled to

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receive payments free of withholding of U.K. income tax under the Treaty and will under current HM Revenue & Customs ("HMRC") administrative procedures be able to make a claim for the issuance of a direction by HMRC to this effect. However, such directions will be issued only on prior application to the relevant tax authorities by the holder in question. If such a direction is not given, we will generally be required to withhold tax, although a U.S. holder entitled to relief under the Treaty may subsequently claim the amount withheld from HMRC.

On November 26, 2013, draft U.K. Taxation of Regulatory Capital Securities Regulations 2013 were published by HMRC. If these draft regulations become effective in their currently proposed form, one of the effects of these draft regulations would be to introduce a new exemption from the duty to withhold income tax where interest is paid on a regulatory capital security (as defined in the draft regulations) and certain other conditions are met. If brought into force in their currently proposed form, this new exemption would, where applicable, operate in addition to the exemptions described above.

Payments of interest on the Subordinated Notes have a U.K. source and may be chargeable to U.K. tax by direct assessment. Where the payments are made without withholding or deduction, the payments will not be assessed to U.K. tax if you are not resident in the United Kingdom, except if you carry on a trade, profession or vocation in the United Kingdom through a U.K. branch or agency, or in the case of a corporate U.S. holder, if you carry on a trade in the U.K. through a permanent establishment in the U.K. in connection with which the payments are received or to which the Subordinated Notes are attributable, in which case (subject to exemptions for payments received by certain categories of agent) tax may be levied on the U.K. branch or agency or permanent establishment.

Any person in the U.K. paying interest to, or receiving interest on behalf of, certain other persons, may be required to provide information in relation to the payment (including the name and address of the beneficial owner of the interest, whether or not resident in the United Kingdom) to HMRC. HMRC may communicate this information to the tax authorities of other jurisdictions.

Disposal (Including Redemption). Subject to the provisions set out in the next paragraph in relation to temporary non-residents, a U.S. holder will not, upon disposal (including redemption) of a Subordinated Note, be liable for U.K. taxation on gains realized, unless at the time of the disposal the U.S. holder carries on a trade, profession or vocation in the U.K. through a branch or agency in the U.K. or, in the case of a corporate U.S. holder, if the U.S. holder carries on a trade in the U.K. through a permanent establishment in the U.K. and the Subordinated Note was used in or for the purposes of the trade, profession or vocation or acquired for use and used by or held for the purposes of that branch or agency or permanent establishment.

A U.S. holder who is an individual and who has ceased to be resident or ordinarily resident for tax purposes in the U.K. for a period of five tax years or less and who disposes of a Subordinated Note during that period may be liable to U.K. tax on chargeable gains arising during the period of absence in respect of the disposal (including redemption), subject to any available exemption or relief.

A U.S. holder who is an individual or other non-corporation taxpayer will not, upon transfer or redemption of a Subordinated Note, recognize any U.K. income tax charge on accrued but unpaid payments of interest, unless the U.S. holder at any time in the relevant tax year carried on a trade in the United Kingdom through a branch or agency to which the Subordinated Note is attributable.

Annual Tax Charges. Corporate U.S. holders who do not carry on a trade in the United Kingdom through a permanent establishment in the U.K. to which the Subordinated Notes are attributable will not be liable to U.K. tax charges or relief by reference to fluctuations in exchange rates or in respect of profits, gains and losses arising from the Subordinated Notes.

Stamp Duty and Stamp Duty Reserve Tax. Prior to the date of the U.K. bail-in regime coming into force, it is considered that no U.K. stamp duty or stamp duty reserve tax should be payable on the issue, transfer or redemption of the Subordinated Notes.

On or after that date the position on transfer is less clear (although the position on redemption should remain as described above). Instruments of transfer of (or agreements to transfer) Subordinated Notes may potentially be liable to U.K. stamp duty and/or stamp duty reserve tax. However, paperless transfers of (or agreements to transfer) Subordinated Notes held in a clearance service should generally not be liable to stamp duty or, provided that such service has not made an election under Section 97A of the Finance Act 1986 that is applicable to the Subordinated Notes, to stamp duty reserve tax.

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On November 26, 2013, draft U.K. Taxation of Regulatory Capital Securities Regulations 2013 were published by HMRC. If these draft regulations become effective in their currently proposed form, one of the effects of these draft regulations would be to exempt from all stamp duties a transfer of a regulatory capital security (as defined in the draft regulations) provided certain conditions are met.

European Union Directive on Taxation of Savings Income. The Savings Directive requires Member States to provide to the tax authorities of other Member States details of payments of interest and other similar income paid by a person within its jurisdiction to (or for the benefit of) an individual resident in that other Member State or to certain limited types of entities established in that other Member State. However, for a transitional period, Austria and Luxembourg are instead required to operate a withholding system (subject to a procedure whereby, on meeting certain conditions, the beneficial owner of the interest or other income may request that no tax be withheld) unless during such period they elect otherwise (the ending of such transitional period being dependent upon the conclusion of certain other agreements relating to information exchange with certain other countries). On April 10, 2013, the Luxembourg Ministry of Finance announced that Luxembourg's transitional period will end with effect from January 1, 2015. A number of non-EU countries and territories including Switzerland have adopted similar measures to the Savings Directive (a withholding system in the case of Switzerland). The European Commission has proposed certain amendments to the Savings Directive, which may, if implemented amend or broaden the scope of the requirements described above.

United States

Payments of Interest. Interest on a Subordinated Note (including any U.K. tax withheld) will be includable in income by a U.S. holder as ordinary interest income at the time it accrues or is received in accordance with the U.S. holder's method of accounting for U.S. federal income tax purposes. Interest income from the Subordinated Notes (including any U.K. tax withheld) will constitute foreign source income, which may be relevant to a U.S. holder in calculating the U.S. holder's foreign tax credit limitation. The limitation on foreign taxes eligible for credit is calculated separately with respect to specific classes of income.

Sale, Exchange or Redemption. A U.S. holder will, upon sale, exchange or redemption of a Subordinated Note, generally recognize capital gain or loss for U.S. federal income tax purposes in an amount equal to the difference between the amount realized (not including amounts attributable to accrued interest, which will be treated as ordinary interest income) and the U.S. holder's tax basis in the Subordinated Note. Any gain or loss will generally be U.S. source capital gain or loss and will be treated as long-term capital gain or loss if the Subordinated Note has been held for more than one year at the time of disposition. The deductibility of capital losses is subject to limitations.

Backup Withholding and Information Reporting. Information returns may be filed with the Internal Revenue Service in connection with payments on the Subordinated Notes and the proceeds from a sale or other disposition of the Subordinated Notes. A U.S. holder may be subject to backup withholding at a current rate of 28% on these payments and proceeds if the U.S. holder fails to provide its taxpayer identification number and comply with certain certification procedures or otherwise establish an exemption from backup withholding. The amount of any backup withholding from a payment to a U.S. holder will be allowed as a credit against the U.S. holder's U.S. federal income tax liability and may entitle the U.S. holder to a refund, provided that the required information is furnished to the Internal Revenue Service.

Certain U.S. holders who are individuals (and under proposed Treasury Regulations, certain entities) may be required to report information relating to non-U.S. accounts through which the U.S. holders may hold their Subordinated Notes (or information regarding the Subordinated Notes if the Subordinated Notes are not held through any financial institution). U.S. holders should consult their tax advisers regarding their reporting obligations with respect to the

Subordinated Notes.

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UNDERWRITING/CONFLICTS OF INTEREST

We and the underwriters for the offering named below (the “Underwriters”) have entered into an underwriting agreement and a pricing agreement with respect to the Subordinated Notes. Subject to certain conditions, we have agreed to sell to the Underwriters and each Underwriter has severally agreed to purchase the respective principal amounts of the Subordinated Notes indicated opposite such Underwriter’s name in the following table.

Underwriters	Principal Amount of Subordinated Notes
RBS Securities Inc.	\$1,120,000,000
Credit Suisse Securities (USA) LLC	200,000,000
J.P. Morgan Securities LLC	200,000,000
Morgan Stanley & Co. LLC	200,000,000
CIBC World Markets Corp.	50,000,000
TD Securities (USA) LLC	50,000,000
BMO Capital Markets Corp.	25,000,000
BNY Mellon Capital Markets, LLC	25,000,000
Capital One Securities, Inc.	25,000,000
Citigroup Global Markets Inc.	25,000,000
Danske Markets Inc.	25,000,000
RBC Capital Markets, LLC	25,000,000
Wells Fargo Securities, LLC	25,000,000
Mischler Financial Group, Inc.	5,000,000
Total	2,000,000,000

The underwriting agreement and the pricing agreement provide that the obligations of the Underwriters are subject to certain conditions precedent and that the Underwriters have undertaken to purchase all the Subordinated Notes offered by this prospectus supplement if any of these Subordinated Notes are purchased.

Subordinated Notes sold by the Underwriters to the public will initially be offered at the initial public offering price set forth on the cover of this prospectus supplement and may be offered to certain dealers at such initial public offering price less a selling concession not to exceed 0.300% of the principal amount of the Subordinated Notes. The Underwriters may allow, and dealers may re-allow, a concession on sales to other dealers not to exceed 0.075% of the principal amount of the Subordinated Notes. If all the Subordinated Notes are not sold at the initial public offering price, the Underwriters may change the offering price and the other selling terms.

We intend to apply for the listing of the Subordinated Notes on the New York Stock Exchange. The Subordinated Notes are a new issue of securities with no established trading market. We have been advised by the Underwriters that the Underwriters intend to make a market in the Subordinated Notes, but they are not obligated to do so and may discontinue market-making at any time without notice. No assurance can be given as to the liquidity of the trading market for the Subordinated Notes.

The Subordinated Notes will settle through the facilities of the DTC and its participants (including Euroclear and Clearstream Banking). The CUSIP 780097AZ4 number for the Subordinated Notes is and the ISIN is US780097AZ42.

Certain of the Underwriters may not be U.S. registered broker-dealers and accordingly will not effect any sales within the United States except in compliance with applicable U.S. laws and regulations, including the rules of the Financial Industry Regulatory Authority (“FINRA”).

We estimate that our total expenses for the offering, excluding underwriting commissions, will be approximately \$400,000. Certain of the underwriters have agreed to reimburse us for a portion of our expenses.

We have agreed to indemnify the several Underwriters against certain liabilities, including liabilities under the Securities Act of 1933, as amended.

It is expected that delivery of the Subordinated Notes will be made against payment on or about the date specified in the last paragraph of the cover page of this prospectus supplement, which will be the third Business Day

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following the date of pricing of the Subordinated Notes (such settlement cycle being referred to as “T+3”). Trades in the secondary market generally are required to settle in three Business Days, unless the parties to any such trade expressly agree otherwise. Accordingly, purchasers who wish to trade Subordinated Notes on the date of pricing or the next succeeding Business Day will be required, by virtue of the fact that the Subordinated Notes initially will settle in T+3, to specify an alternate settlement cycle at the time of any such trade to prevent a failed settlement. Purchasers of Subordinated Notes who wish to trade Subordinated Notes on the date of pricing or the next Business Day should consult their own advisors.

Conflicts of Interest

RBSSI, an affiliate of RBSG, is a FINRA member and an Underwriter in this offering, and has a “conflict of interest” within the meaning of FINRA Rule 5121. Accordingly, this offering will be made in compliance with the applicable provisions of FINRA Rule 5121. RBSSI is not permitted to sell Subordinated Notes in this offering to an account over which it exercises discretionary authority without the prior specific written approval of the account holder.

Some of the Underwriters and their affiliates have engaged in, and may in the future engage in, investment banking and other commercial dealings in the ordinary course of business with us or our affiliates. They have received, or may in the future receive, customary fees and commissions for these transactions. In addition, in the ordinary course of their business activities, the Underwriters and their affiliates may make or hold a broad array of investments and actively trade debt and equity securities (or related derivative securities) and financial instruments (including bank loans) for their own account and for the accounts of their customers. Such investments and securities activities may involve securities and/or instruments of ours or our affiliates. Certain of the Underwriters or their affiliates that have a lending relationship with us routinely hedge their credit exposure to us consistent with their customary risk management policies. Typically, such Underwriters and their affiliates would hedge such exposure by entering into transactions which consist of either the purchase of credit default swaps or the creation of short positions in our securities, including potentially the notes offered hereby. Any such short positions could adversely affect future trading prices of the notes offered hereby. The Underwriters and their affiliates may also make investment recommendations and/or publish or express independent research views in respect of such securities or financial instruments and may hold, or recommend to clients that they acquire, long and/or short positions in such securities and instruments.

In connection with the offering, the Underwriters are not acting for anyone other than us and will not be responsible to anyone other than us for providing the protections afforded to their clients nor for providing advice in relation to the offering.

Stabilization Transactions and Short Sales

In connection with the offering, each Underwriter (or any person acting for such Underwriter) may engage in short sales, stabilizing transactions and purchases to cover positions created by short sales.

Short sales involve the sale by the Underwriters of a greater aggregate principal amount of Subordinated Notes than they are required to purchase from us in the offering.

Stabilizing transactions consist of certain bids or purchases made for the purpose of preventing or retarding a decline in the market price of the Subordinated Notes while the offering is in progress. Each Underwriter (or any person acting for such Underwriter) may over-allot Subordinated Notes or effect transactions with a view to supporting the market price of the Subordinated Notes at a level higher than that which might otherwise prevail. However, there is no obligation or assurance that any Underwriter (or any person acting on behalf of such Underwriter) will undertake any such stabilization action. Any such stabilization action may begin on or after the date on which adequate public

disclosure of the terms of the offer of the Subordinated Notes is made, and, if begun, may be ended at any time, but it must end no later than 30 days after the date on which the Issuer received the proceeds of the issue, or no later than 60 days after the date of allotment of the relevant Subordinated Notes, whichever is the earlier.

Each Underwriter may also impose a penalty bid. This occurs when a particular Underwriter repays to the other Underwriters a portion of the underwriting discount received by it because the other Underwriters have repurchased Subordinated Notes sold by or for the account of such Underwriter in stabilizing or short-covering transactions.

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These activities by the Underwriters may stabilize, maintain or otherwise affect the market price of the Subordinated Notes. As a result, the price of the Subordinated Notes may be higher than the price that otherwise might exist in the open market.

These transactions may be effected on the New York Stock Exchange, in over-the-counter markets or otherwise.

Selling Restrictions

United Kingdom

This prospectus supplement is for distribution only to persons who (i) have professional experience in matters relating to investments falling within Article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (as amended, the “Financial Promotion Order”), (ii) are persons falling within Article 49(2)(a) to (d) (“high net worth companies, unincorporated associations etc.”) of the Financial Promotion Order, (iii) are outside the United Kingdom, or (iv) are persons to whom an invitation or inducement to engage in investment activity (within the meaning of Section 21 of the U.K. Financial Services and Markets Act 2000 (“FSMA”)) in connection with the issue or sale of any securities may otherwise lawfully be communicated or caused to be communicated (all such persons together being referred to as “relevant persons”). This prospectus supplement is directed only at relevant persons and must not be acted on or relied on by persons who are not relevant persons. Any investment or investment activity to which this prospectus supplement relates is available only to relevant persons and will be engaged in only with relevant persons.

Each Underwriter has represented and agreed that:

- (a) it has only communicated or caused to be communicated and will only communicate or cause to be communicated an invitation or inducement to engage in investment activity (within the meaning of Section 21 of the FSMA) received by it in connection with the issue or sale of the Subordinated Notes in circumstances in which Section 21(1) of the FSMA does not apply to us; and
- (b) it has complied and will comply with all applicable provisions of the FSMA with respect to anything done by it in relation to the Subordinated Notes in, from or otherwise involving the United Kingdom.

European Economic Area

This prospectus supplement has been prepared on the basis that, except to the extent sub-paragraph (ii) below may apply, any offer of the Subordinated Notes in any Member State of the European Economic Area which has implemented the Prospectus Directive (each, a “Relevant Member State”), will be made pursuant to an exemption under the Prospectus Directive, as implemented in that Relevant Member State, from the requirement to publish a prospectus for offers of Subordinated Notes. Accordingly any person making or intending to make an offer in that Relevant Member State of Subordinated Notes which are the subject of an offering contemplated in this prospectus supplement may only do so (i) in circumstances in which no obligation arises for us or any Underwriter to publish a prospectus pursuant to Article 3 of the Prospectus Directive or supplement a prospectus pursuant to Article 16 of the Prospectus Directive, in each case, in relation to such offer, or (ii) if a prospectus for such offer has been approved by the competent authority in that Relevant Member State or, where appropriate, approved in another Relevant Member State and notified to the competent authority in that Relevant Member State and (in either case) published, all in accordance with the Prospectus Directive, provided that any such prospectus has subsequently been completed by a prospectus supplement which specifies that offers may be made other than pursuant to Article 3(2) of the Prospectus Directive in that Relevant Member State, such offer is made in the period beginning and ending on the dates specified for such purpose in such prospectus or prospectus supplement, as applicable, and we have consented in writing to its use for

the purpose of such offer. Except to the extent sub-paragraph (ii) above may apply, neither we nor any Underwriter have authorized, nor authorize, the making of any offer of Subordinated Notes in circumstances in which an obligation arises for us or any Underwriter to publish or supplement a prospectus for such offer.

In relation to each Relevant Member State, each Underwriter has severally represented and agreed that with effect from and including the date on which the Prospectus Directive is implemented in that Relevant Member State (the “Relevant Implementation Date”) it has not made and will not make an offer of Subordinated Notes to the public in that Relevant Member State other than:

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- (a) to any legal entity which is a qualified investor as defined in the Prospectus Directive;
- (b) to fewer than 100 or, if the Relevant Member State has implemented the relevant provision of the 2010 PD Amending Directive, 150, natural or legal persons (other than qualified investors as defined in the Prospectus Directive), as permitted under the Prospectus Directive, subject to obtaining the prior consent of the other Underwriters for any such offer; or
- (c) in any other circumstances falling within Article 3(2) of the Prospectus Directive,

provided that no such offer of Subordinated Notes shall require us or any Underwriter to publish a prospectus pursuant to Article 3 of the Prospectus Directive or a supplemental prospectus pursuant to Article 16 of the Prospectus Directive.

For the purposes of this section, the expression “an offer of the Subordinated Notes to the public” in relation to any Subordinated Notes in any Relevant Member State means the communication in any form and by any means of sufficient information on the terms of the offer and the Subordinated Notes to be offered so as to enable an investor to decide to purchase or subscribe for the Subordinated Notes, as the same may be varied in that Relevant Member State by any measure implementing the Prospectus Directive in that Relevant Member State, the expression Prospectus Directive means Directive 2003/71/EC (and amendments thereto, including the 2010 PD Amending Directive, to the extent implemented in the Relevant Member State), and includes any relevant implementing measure in the Relevant Member State and the expression “2010 PD Amending Directive” means Directive 2010/73/EU.

Hong Kong

The Subordinated Notes may not be offered or sold in Hong Kong by means of any document other than (i) in circumstances which do not constitute an offer to the public within the meaning of the Companies Ordinance (Cap.32, Laws of Hong Kong), or (ii) to “professional investors” within the meaning of the Securities and Futures Ordinance (Cap.571, The Laws of Hong Kong) and any rules made thereunder, or (iii) in other circumstances which do not result in the document being a “prospectus” within the meaning of the Companies Ordinance, and no advertisement, invitation or document relating to the Subordinated Notes may be issued or may be in the possession of any person for the purpose of issue (in each case whether in Hong Kong or elsewhere), which is directed at, or the contents of which are likely to be accessed or read by, the public in Hong Kong (except if permitted to do so under the laws of Hong Kong) other than with respect to Subordinated Notes which are or are intended to be disposed of only to persons outside Hong Kong or only to “professional investors” within the meaning of the Securities and Futures Ordinance and any rules made thereunder.

Japan

The Subordinated Notes have not been and will not be registered under the Financial Instruments and Exchange Law of Japan (Law No. 25 of 1919, as amended) (the “FIEL”) and, accordingly, will not be offered or sold, directly or indirectly, in Japan or to, or for the benefit of, any resident of Japan (which term as used herein means any person resident in Japan, including any corporation or other entity organized under the laws of Japan), or to others for re-offering or resale, directly or indirectly, in Japan or to, or for the benefit of, a resident of Japan, except pursuant to an exemption from the registration requirements of, and otherwise in compliance with, the FIEL and any other applicable laws, regulations and ministerial guidelines of Japan promulgated by relevant Japanese governmental or regulatory authorities in effect at the relevant time.

Singapore

This prospectus supplement and accompanying prospectus have not been registered as a prospectus with the Monetary Authority of Singapore. Accordingly, this prospectus supplement and accompanying prospectus and any other document or material in connection with the offer or sale, or invitation for subscription or purchase, of the Subordinated Notes may not be circulated or distributed, nor may the Subordinated Notes be offered or sold, or be made the subject of an invitation for subscription or purchase, whether directly or indirectly, to persons in Singapore other than (i) to an institutional investor under Section 274 of the Securities and Futures Act (Chapter 289) (the “SFA”), (ii) to a relevant person, or any person pursuant to Section 275(1A), and in accordance with the conditions, specified in Section 275 of the SFA or (iii) otherwise pursuant to, and in accordance with the conditions of, any other applicable provision of the SFA.

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Where the Subordinated Notes are subscribed or purchased under Section 275 of the Securities and Futures Act by a relevant person which is:

- (a) a corporation (which is not an accredited investor (as defined in Section 4A of the Securities and Futures Act)) the sole business of which is to hold investments and the entire share capital of which is owned by one or more individuals, each of whom is an accredited investor; or
- (b) a trust (where the trustee is not an accredited investor) whose sole purpose is to hold investments and each beneficiary of the trust is an individual who is an accredited investor, then

“securities” (as defined in Section 239(1) of the Securities and Futures Act) of that corporation or the beneficiaries’ rights and interest (howsoever described) in that trust shall not be transferrable for six months after that corporation or that trust has acquired the Subordinated Notes pursuant to an offer made under Section 275 of the Securities and Futures Act except:

- (i) to an institutional investor under Section 274 of the SFA or to a relevant person defined in Section 275(2) of the Securities and Futures Act, or to any person arising from an offer referred to in Section 275(1A) or Section 276(4)(i)(B) of the Securities and Futures Act;
 - (ii) where no consideration is or will be given for the transfer;
 - (iii) where the transfer is by operation of law;
 - (iv) as specified in Section 276(7) of the Securities and Futures Act; or
- (v) as specified in Regulation 32 of the Securities and Futures (Offers of Investments) (Shares and Debentures) Regulations 2005 of Singapore.

Switzerland

This prospectus supplement, as well as any other material relating to the Subordinated Notes which are the subject of the offering contemplated by this prospectus supplement and the accompanying prospectus, do not constitute an issue prospectus pursuant to Articles 652a and/or 1156 of the Swiss Code of Obligations. The Subordinated Notes will not be listed on the SIX Swiss Exchange and, therefore, the documents relating to the Subordinated Notes, including, but not limited to, this prospectus supplement, do not claim to comply with the disclosure standards of the listing rules of the SIX Swiss Exchange and corresponding prospectus schemes annexed to the listing rules of the SIX Swiss Exchange. The Subordinated Notes are being offered in Switzerland by way of a private placement, i.e. to a small number of selected investors only, without any public offer and only to investors who do not purchase the Subordinated Notes with the intention to distribute them to the public. The investors will be individually approached by us from time to time. This prospectus supplement as well as any other material relating to the Subordinated Notes is personal and confidential and does not constitute an offer to any other person. This prospectus supplement may only be used by those investors to whom it has been handed out in connection with the offering described herein and may neither directly nor indirectly be distributed or made available to other persons without our express consent. It may not be used in connection with any other offer and shall in particular not be copied and/or distributed to the public in (or from) Switzerland.

Other Jurisdictions outside the United States

No action may be taken in any jurisdiction other than the United States that would permit a public offering of the Subordinated Notes or the possession, circulation or distribution of this prospectus supplement in any jurisdiction where action for that purpose is required. Accordingly, the Subordinated Notes may not be offered or sold, directly or indirectly, and neither this prospectus supplement nor any other offering material or advertisements in connection with the Subordinated Notes may be distributed or published in or from any country or jurisdiction, except under circumstances that will result in compliance with any applicable rules and regulations of any such country or jurisdiction.

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LEGAL OPINIONS

Our U.S. counsel, Davis Polk & Wardwell London LLP, and U.S. counsel for the Underwriters, Shearman & Sterling (London) LLP, will pass upon certain United States legal matters relating to the Subordinated Notes. Our Scottish solicitors, Dundas & Wilson C.S. LLP, will pass upon certain matters of Scots law relating to the issue and sale of the Subordinated Notes. Our English solicitors, Linklaters LLP, will pass upon certain matters of English law relating to the issue and sale of the Subordinated Notes, and Davis Polk & Wardwell London LLP will pass upon certain tax matters of English law relating to the Subordinated Notes.

EXPERTS

The consolidated financial statements, incorporated in this prospectus supplement by reference from our 2012 Annual Report, as at December 31, 2012, 2011 and 2010 and for each of the three years in the period ended December 31, 2012, and the effectiveness of our internal control over financial reporting have been audited by Deloitte LLP, an independent registered public accounting firm, as stated in their reports, which are incorporated herein by reference (which reports (1) express an unqualified opinion on the financial statements as of December 31, 2012, 2011 and 2010 and include an explanatory paragraph stating that Note 43 to the financial statements was added for the inclusion of consolidating financial information in respect of RBS plc in accordance with Regulation S-X Rule 3-10 and (2) express an unqualified opinion on the effectiveness of internal control over financial reporting). Such financial statements have been so incorporated in reliance upon the reports of such firm given upon their authority as experts in accounting and auditing.

PROSPECTUS

THE ROYAL BANK OF SCOTLAND GROUP plc

By this prospectus we may offer —

DEBT SECURITIES

DOLLAR PREFERENCE SHARES

THE ROYAL BANK OF SCOTLAND plc

fully and unconditionally guaranteed by THE ROYAL BANK OF SCOTLAND GROUP plc

By this prospectus we may offer —

DEBT SECURITIES

The Royal Bank of Scotland Group plc may use this prospectus to offer from time to time debt securities, including senior debt securities, subordinated debt securities and capital securities, or dollar preference shares, directly or in the form of American Depositary Shares. Our American Depositary Shares, or ADSs, each representing one ordinary share (or a right to receive one ordinary share), and evidenced by an American Depositary Receipt or uncertificated securities, are listed on the New York Stock Exchange under the symbol “RBS”. In addition, our ordinary shares are listed on the London Stock Exchange. Our series of American Depositary Shares representing non-cumulative dollar preference shares and evidenced by American Depositary Receipts (Series F, Series H, Series L, Series M, Series N, Series P, Series Q, Series R, Series S, Series T, and Series U) are listed on the New York Stock Exchange.

The Royal Bank of Scotland plc (acting through its head office or any one of its branches) may use this prospectus to offer from time to time senior debt securities or subordinated debt securities. Such senior debt securities and subordinated debt securities will be fully and unconditionally guaranteed by The Royal Bank of Scotland Group plc.

We will provide the specific terms of these securities, and the manner in which they will be offered, in one or more supplements to this prospectus. Any supplement may also add, update or change information contained, or incorporated by reference, into this prospectus. You should read this prospectus and the applicable prospectus supplement carefully before you invest in our securities.

You should read both this prospectus and the applicable prospectus supplement, together with the additional information described under the headings “Where You Can Find More Information” and “Incorporation of Documents by Reference”, before investing in our securities. The amount and price of the offered securities will be determined at the time of the offering.

Investing in our securities involves risks that are described in the “Risk Factors” section of our annual reports filed with the Securities and Exchange Commission or in the applicable prospectus supplement.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined that this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

This prospectus may not be used to sell securities unless it is accompanied by a prospectus supplement.

The date of this prospectus is September 28, 2012.

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ABOUT THIS PROSPECTUS

This prospectus is part of a registration statement on Form F-3 that we filed with the Securities and Exchange Commission (“SEC”) using a “shelf” registration or continuous offering process. Under this shelf process, we may sell the securities described in this prospectus in one or more offerings of an unspecified amount in one or more foreign currencies or currency units.

This prospectus provides you with a general description of the debt securities and dollar preference shares we may offer, which we will refer to collectively as the “securities”. Each time we sell securities, we will provide a prospectus supplement that will contain specific information about the terms of that offering. The prospectus supplement will provide information regarding certain tax consequences of the purchase, ownership and disposition of the offered securities. The prospectus supplement may also add to, update or change information contained in this prospectus. If there is any inconsistency between the information in this prospectus and any prospectus supplement, you should rely on the information in that prospectus supplement. We will file each prospectus supplement with the SEC. You should read both this prospectus and the applicable prospectus supplement, together with the additional information described under the headings “Where You Can Find More Information” and “Incorporation of Documents by Reference”.

The registration statement containing this prospectus, including exhibits to the registration statement, provides additional information about us and the securities offered under this prospectus. The registration statement can be read at the SEC’s offices or obtained from the SEC’s website mentioned under the heading “Where You Can Find More Information”.

Certain Terms

In this prospectus,

- the term “RBSG” means The Royal Bank of Scotland Group plc, the term “Group” means The Royal Bank of Scotland Group plc and its subsidiaries;
- the term “RBS plc” means The Royal Bank of Scotland plc, the term “RBS” or the “Royal Bank” means RBS plc and its subsidiaries, the term “NWB Plc” means National Westminster Bank Plc and the term “NatWest” means NWB Plc and its subsidiaries;
- the terms “we”, “our” and “us” refer to each of RBSG or RBS plc, as applicable, as issuer of the relevant securities; and
- in the sections titled “Description of Dollar Preference Shares” and “Description of American Depositary Receipts”, the terms “we”, “our” and “us” refer to RBSG as issuer of the dollar preference shares and American Depositary Receipts.

RBSG publishes its consolidated financial statements in pounds sterling (“£” or “sterling”), the lawful currency of the United Kingdom. In this prospectus and any prospectus supplement, references to “dollars” and “\$” are to United States dollars.

As permitted by Rule 12h-5 under the Securities Exchange Act of 1934, as amended (the “Exchange Act”), RBS plc does not file reports under the Exchange Act with the SEC. In accordance with Rule 3-10 of Regulation S-X under the Securities Act of 1933, as amended (the “Securities Act”), the Group’s financial statements include condensed consolidating financial information for RBS in a footnote to those financial statements.

USE OF PROCEEDS

Unless we have disclosed a specific plan in the accompanying prospectus supplement, we will use the net proceeds from the sale of the securities offered by this prospectus for general corporate purposes. The Group has raised capital in various markets from time to time and we expect to continue to raise capital in appropriate markets as and when required.

THE ROYAL BANK OF SCOTLAND GROUP PLC

RBSG is a public limited company incorporated in Scotland with registration number SC045551. RBSG was incorporated under Scots law on March 25, 1968. RBSG is the holding company of a large global banking and financial services group. Headquartered in Edinburgh, the Group operates in the United Kingdom, the United States and internationally through its two principal subsidiaries, RBS and NatWest. Both RBS and NatWest are major U.K. clearing banks. In the United States, the Group's subsidiary RBS Citizens Financial Group, Inc. is a large commercial banking organization. Globally, the Group has a diversified customer base and provides a wide range of products and services to personal, commercial and large corporate and institutional customers.

Following the placing and open offers in December 2008 and in April 2009, Her Majesty's Treasury ("HM Treasury") owned approximately 70.3% of the enlarged ordinary share capital of RBSG. In December 2009, RBSG issued a further £25.5 billion of new capital to HM Treasury. This new capital took the form of B shares, which do not generally carry voting rights at general meetings of ordinary shareholders but are convertible into ordinary shares and qualify as Core Tier 1 capital. Following the issuance of the B shares, HM Treasury's holding of ordinary shares of RBSG remained at 70.3% although its economic interest rose to 84.4%. At June 30, 2012, HM Treasury's holding in RBSG's ordinary shares was 66.9% and its economic interest was 82.2%.

In 2007, RFS Holdings B.V., which was jointly owned by the Group, the Dutch State (successor to Fortis) and Santander (together, the "Consortium Members") completed the acquisition of ABN AMRO Holding N.V. On February 6, 2010, the businesses of ABN AMRO Holding N.V. acquired by the Dutch State were legally demerged to a newly established company, ABN AMRO Bank N.V., which on April 1, 2010 was transferred to ABN AMRO Group N.V., itself owned by the Dutch State. Following legal separation, RBS Holdings N.V. (formerly ABN AMRO Holding N.V.) has one operating subsidiary, The Royal Bank of Scotland N.V. ("RBS N.V."), a fully operational bank within the Group. RBS N.V. is independently rated and regulated by the Dutch Central Bank. Certain assets within RBS N.V. continue to be shared by the Consortium Members.

On April 19, 2011, the Group announced the intended transfer of a substantial part of the business activities of RBS N.V. to RBS plc. This transfer is substantially complete as of the date of this registration statement. On October 17, 2011, the Group transferred a substantial part of the UK activities of RBS N.V. to RBS plc pursuant to Part VII of the UK Financial Services and Markets Act 2000. On September 10, 2012, the Group further transferred a substantial part of the business conducted by RBS N.V. in the Netherlands as well as in certain EMEA branches of RBS N.V. and certain securities issued by RBS N.V. to RBS plc by way of a Dutch statutory demerger. The remaining transfers are being implemented on a phased basis over a period ending December 31, 2013.

RBSG's registered office is 36 St Andrew Square, Edinburgh EH2 2YB, Scotland and its principal place of business is RBS Gogarburn, PO Box 1000, Edinburgh EH12 1HQ, Scotland, telephone +44 131 626 0000.

THE ROYAL BANK OF SCOTLAND PLC

RBS plc is a public limited company incorporated in Scotland with registration number SC090312. RBS plc was incorporated under Scots law on October 31, 1984. RBS is a wholly owned subsidiary of RBSG.

RBS plc's registered office is 36 St Andrew Square, Edinburgh EH2 2YB, Scotland and its principal place of business is RBS Gogarburn, PO Box 1000, Edinburgh EH12 1HQ, Scotland, telephone +44 131 626 0000.

DESCRIPTION OF DEBT SECURITIES

The following is a summary of the general terms that will apply to (i) any senior debt securities, subordinated debt securities and capital securities that may be offered by RBSG, and (ii) any senior debt securities and subordinated debt securities that may be offered by RBS plc (acting through its head office or any one of its branches) and guaranteed by RBSG. Consequently, when we refer to “debt securities” in this prospectus, we mean (i) the senior debt securities, the subordinated debt securities and the capital securities that may be issued by RBSG, or (ii) the senior debt securities and subordinated debt securities that may be issued by RBS plc, acting directly or through one of its branches, as applicable.

Each time that we issue debt securities, we will file a prospectus supplement with the SEC, which you should read carefully. The prospectus supplement will summarize specific financial terms of your security and may contain additional terms of those debt securities to those described in this prospectus. The terms presented here, together with the terms contained in the prospectus supplement, will be a description of the material terms of the debt securities, but if there is any inconsistency between the terms presented here and those in the prospectus supplement, those in the prospectus supplement will apply and will replace those presented here. Therefore, the statements we make below in this section may not apply to your debt security. You should also read the indentures under which we will issue the debt securities, which we have filed with the SEC as exhibits to the registration statement of which this prospectus is a part.

Senior debt securities will be issued by RBSG and/or RBS plc under the relevant senior debt indenture. Senior debt securities issued by RBS plc will be fully and unconditionally guaranteed on a senior basis by RBSG. Subordinated debt securities will be issued by RBSG and/or RBS plc under the relevant subordinated debt indenture. Subordinated debt securities issued by RBS plc will be fully and unconditionally guaranteed on a subordinated basis by RBSG. Capital debt securities that have no stated maturity will be issued by RBSG under a capital securities indenture. Each indenture is a contract between us and The Bank of New York Mellon or Wilmington Trust Company, as applicable, as trustee, Citibank, N.A., as securities administrator for RBS NotesSM and Retail Corporate Notes issued by RBS plc, and, in respect of the senior debt securities or subordinated debt securities issued by RBS plc, RBSG, as guarantor. The indentures are substantially identical, except for certain provisions such as those relating to subordination, which are included only in the subordinated debt indentures and the capital securities indenture. None of the indentures limit our ability to incur additional indebtedness, including additional senior indebtedness.

General

The debt securities are not deposits and are not insured or guaranteed by the U.S. Federal Deposit Insurance Corporation or any other government agency of the United States or the United Kingdom.

The indentures do not limit the amount of debt securities that we may issue. We may issue debt securities in one or more series. The relevant prospectus supplement for any particular series of debt securities will describe the terms of the offered debt securities, including some or all of the following terms:

- whether RBSG or RBS plc (acting through its head office or any one of its branches) is the issuer of the relevant debt securities;
- whether they are senior debt securities or subordinated debt securities or, in the case of debt securities issued by RBSG only, capital securities;
 - whether the senior debt securities or subordinated debt securities are guaranteed;
- with respect to the subordinated debt securities and capital securities, whether the payment of interest can be deferred, whether the payment of principal can be deferred, the subordination terms, whether the principal amount may be written down or converted into equity upon the occurrence of certain events relating to our financial condition, the redemption terms and the events of default applicable to each series of the subordinated debt securities and capital securities;
 - their specific designation, authorized denomination and aggregate principal amount;
 - the price or prices at which they will be issued;

- whether such debt securities will be dated debt securities with a specified maturity date or undated debt securities with no specified maturity date;
 - the annual interest rate or rates, or how to calculate the interest rate or rates;
 - the date or dates from which interest, if any, will accrue or the method, if any, by which such date or dates will be determined;
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- whether payments are subject to certain conditions that relate to our financial condition, including our capital ratios;
 - the times and places at which any interest payments are payable;
 - the terms of any mandatory or optional redemption, including the amount of any premium;
 - any modifications or additions to the events of default with respect to the debt securities offered;
 - any provisions relating to conversion or exchange for other securities issued by us;
 - the currency or currencies in which they are denominated and in which we will make any payments;
 - any index used to determine the amount of any payments on the debt securities;
- any restrictions that apply to the offer, sale and delivery of the debt securities and the exchange of debt securities of one form for debt securities of another form;
- whether and under what circumstances, if other than those described in this prospectus, we will pay additional amounts on the debt securities following certain developments with respect to withholding tax or information reporting laws and whether, and on what terms, if other than those described in this prospectus, we may redeem the debt securities following those developments;
 - the terms of any mandatory or optional exchange; and
 - any listing on a securities exchange.

In addition, the prospectus supplement will describe the material U.S. federal and U.K. tax considerations that apply to any particular series of debt securities.

Debt securities may bear interest at a fixed rate or a floating rate. We will sell any subordinated debt securities that bear no interest, or that bear interest at a rate that at the time of issuance is below the prevailing market rate, at a discount to their stated principal amount.

Holders of debt securities shall have no voting rights except those described under the heading “— Modification and Waiver” below.

If RBSG issues subordinated debt securities or capital securities, and if RBS plc issues subordinated debt securities, that, in each case, qualify as Tier 1 or Tier 2 capital or other capital for regulatory purposes, the payment, subordination, redemption, events of default and other terms may vary from those described in this prospectus and will be set forth in the relevant prospectus supplement.

Guarantee for Debt Securities Issued by RBS plc

RBSG will fully and unconditionally guarantee payment in full to the holders of senior debt securities or subordinated debt securities issued by RBS plc and all amounts due and owing under the applicable indenture. The guarantee is set forth in, and forms part of, the indentures under which senior debt securities or subordinated debt securities, as applicable, will be issued by RBS plc.

Senior Debt Securities

If, for any reason, RBS plc does not make any required payment in respect of its senior debt securities when due, RBSG will cause the payment to be made to or to the order of the applicable trustee. The guarantee will be on a senior basis when the guaranteed debt securities are issued under the senior indenture. Holders of senior debt securities issued by RBS plc may sue RBSG to enforce their rights under the guarantee without first suing any other person or entity. RBSG may, without the consent of the holders of the debt securities, assume all of RBS plc's rights and obligations under the debt securities and upon such assumption, RBS plc will be released from its liabilities under the senior debt indenture and the senior debt securities.

Subordinated Debt Securities

If, for any reason, RBS plc does not make any required payment in respect of its subordinated debt securities when due, RBSG will cause the payment to be made to or to the order of the applicable trustee. The guarantee will be on a subordinated basis when the guaranteed debt securities are issued under the subordinated debt indenture. Holders of subordinated debt securities issued by RBS plc may sue RBSG to enforce their rights under the subordinated guarantee without first suing any other person or entity. RBSG may, without the consent of the holders of the debt securities, assume all of RBS plc's rights and obligations under the debt securities and upon such assumption, RBS plc will be released from its liabilities under the subordinated debt indenture and subordinated debt securities.

Because the guarantee is subordinated, if winding up proceedings with respect to RBSG should occur, each holder may recover less ratably than the holders of its unsubordinated liabilities. If, in any such winding up, the amount payable on any guarantee of any series of debt securities and any claims ranking equally with such guarantee are not paid in full, those guarantees and other claims ranking equally will share ratably in any distribution of RBSG's assets in a winding up in proportion to the respective amounts to which they are entitled. If any holder is entitled to any recovery with respect to the guarantee of any debt securities in any winding up or liquidation, the holder might not be entitled in those proceedings to a recovery in U.S. dollars and might be entitled only to a recovery in pounds sterling or any other lawful currency of the United Kingdom.

In addition, because RBSG is a holding company, its rights to participate in the assets of any subsidiary if it is liquidated will be subject to the prior claims of such subsidiary's creditors, including, in the case of RBS plc, RBS plc's depositors, except to the extent that RBSG may be a creditor with recognized claims against RBS plc.

Form of Debt Securities; Book-Entry System

General

Unless the relevant prospectus supplement states otherwise, the debt securities shall initially be represented by one or more global securities in registered form, without coupons attached, and will be deposited with or on behalf of one or more depository, including, without limitation, The Depository Trust Company ("DTC"), Euroclear Bank S.A./N.V. ("Euroclear Bank"), as operator of the Euroclear System ("Euroclear") and/or Clearstream Banking, société anonyme ("Clearstream Luxembourg"), and will be registered in the name of such depository or its nominee. Unless and until the debt securities are exchanged in whole or in part for other securities that we issue or the global securities are exchanged for definitive securities, the global securities may not be transferred except as a whole by the depository to a nominee or a successor of the depository.

The debt securities may be accepted for clearance by DTC, Euroclear and Clearstream Luxembourg. Unless the relevant prospectus supplement states otherwise, the initial distribution of the debt securities will be cleared through DTC only. In such event, beneficial interests in the global debt securities will be shown on, and transfers thereof will be effected only through, the book-entry records maintained by DTC and its direct and indirect participants, including, as applicable, Euroclear and Clearstream Luxembourg.

The laws of some states may require that certain investors in securities take physical delivery of their securities in definitive form. Those laws may impair the ability of investors to own interests in book-entry securities.

So long as the depository, or its nominee, is the holder of a global debt security, the depository or its nominee will be considered the sole holder of such global debt security for all purposes under the indentures. Except as described below under the heading "—Issuance of Definitive Securities", no participant, indirect participant or other person will be entitled to have debt securities registered in its name, receive or be entitled to receive physical delivery of debt

securities in definitive form or be considered the owner or holder of the debt securities under the indentures. Each person having an ownership or other interest in debt securities must rely on the procedures of the depository, and, if a person is not a participant in the depository, must rely on the procedures of the participant or other securities intermediary through which that person owns its interest to exercise any rights and obligations of a holder under the indentures or the debt securities.

Payments on the Global Debt Security

Payments of any amounts in respect of any global securities will be made by the trustee to the depository. Payments will be made to beneficial owners of debt securities in accordance with the rules and procedures of the depository or its direct and indirect participants, as applicable. Neither we nor the trustee nor any of our agents will have any responsibility or liability for any aspect of the records of any securities intermediary in the chain of intermediaries between the depository and any beneficial owner of an interest in a global security, or the failure of the depository or any intermediary to pass through to any beneficial owner any payments that we make to the depository.

The Clearing Systems

DTC, Euroclear and Clearstream Luxembourg have advised us as follows:

DTC. DTC, the world's largest securities depository, is a limited-purpose trust company organized under the New York Banking Law, a "banking organization" within the meaning of the New York Banking Law, a member of the Federal Reserve System, a "clearing corporation" within the meaning of the New York Uniform Commercial Code, and a "clearing agency" registered pursuant to the provisions of Section 17A of the Exchange Act. DTC holds securities deposited with it by its participants and facilitates the settlement of transactions among its participants in such securities through electronic computerized book-entry changes in accounts of the participants, thereby eliminating the need for physical movement of securities certificates. Direct participants include both U.S. and non-U.S. securities brokers and dealers, banks, trust companies, clearing corporations, and certain other organizations. DTC is a wholly-owned subsidiary of The Depository Trust & Clearing Corporation ("DTCC"). DTCC is the holding company for DTC, National Securities Clearing Corporation and Fixed Income Clearing Corporation, all of which are registered clearing agencies. DTCC is owned by the users of its regulated subsidiaries. Access to the DTC system is also available to others such as both U.S. and non-U.S. securities brokers and dealers, banks, trust companies, and clearing corporations that clear through or maintain a custodial relationship with a direct participant, either directly or indirectly. The DTC rules applicable to its participants are on file with the SEC. More information about DTC can be found at www.dtcc.com.

Euroclear. Euroclear holds securities for its participants and clears and settles transactions between its participants through simultaneous electronic book-entry delivery against payment, thus eliminating the need for physical movement of certificates. Euroclear provides various other services, including safekeeping, administration, clearance and settlement and securities lending and borrowing, and interfaces with domestic markets in several countries. Euroclear is operated by Euroclear Bank, under contract with Euroclear plc, a U.K. corporation. Euroclear Bank conducts all operations, and all Euroclear securities clearance accounts and Euroclear cash accounts are accounts with Euroclear Bank, not Euroclear plc. Euroclear plc establishes policy for Euroclear on behalf of Euroclear participants. Euroclear participants include banks (including central banks), securities brokers and dealers and other professional financial intermediaries and may include any underwriters for the debt securities. Indirect access to Euroclear is also available to other firms that clear through or maintain a custodial relationship with a Euroclear participant, either directly or indirectly. Euroclear is an indirect participant in DTC. Securities clearance accounts and cash accounts with Euroclear are governed by the Terms and Conditions Governing Use of Euroclear and the related Operating Procedures of the Euroclear System (collectively, the "Euroclear Terms and Conditions") and applicable law. The Euroclear Terms and Conditions govern transfers of securities and cash within Euroclear, withdrawals of securities and cash from Euroclear, and receipts of payments with respect to securities in Euroclear.

Clearstream Luxembourg. Clearstream Luxembourg is incorporated under the laws of The Grand Duchy of Luxembourg as a société anonyme and is subject to regulation by the Luxembourg Commission for the Supervision of the Financial Sector (Commission de Surveillance du Secteur Financier). Clearstream Luxembourg is owned by Deutsche Börse AG, a publicly traded company. Clearstream Luxembourg holds securities for its participants and

facilitates the clearance and settlement of securities transactions among its participants through electronic book-entry changes in accounts of its participants, thereby eliminating the need for physical movement of certificates. Clearstream Luxembourg provides other services to its participants, including safekeeping, administration, clearance and settlement of internationally traded securities and securities lending and borrowing. Clearstream Luxembourg interfaces with domestic markets in several countries. Clearstream Luxembourg's customers include worldwide securities brokers and dealers, banks, trust companies and clearing corporations and may include professional

financial intermediaries. Its U.S. customers are limited to securities brokers, dealers and banks. Indirect access to the Clearstream Luxembourg system is also available to others that clear through Clearstream Luxembourg customers or that have custodial relationships with its customers, such as banks, brokers, dealers and trust companies. Clearstream Luxembourg is an indirect participant in DTC. Clearstream Luxembourg has established an electronic bridge with Euroclear to facilitate settlement of trades between Clearstream Luxembourg and Euroclear. Distributions with respect to the securities held beneficially through Clearstream Luxembourg are credited to cash accounts of Clearstream Luxembourg customers in accordance with its rules and procedures, to the extent received by Clearstream Luxembourg.

Issuance of Definitive Securities

So long as the depository holds the global securities of a particular series of debt securities, such global securities will not be exchangeable for definitive securities of that series unless:

- the depository notifies the trustee that it is unwilling or unable to continue to act as depository for the debt securities or the depository ceases to be a clearing agency registered under the Exchange Act;
 - we are wound up and we fail to make a payment on the debt securities when due; or
- at any time we determine at our option and in our sole discretion that the global securities of a particular series of debt securities should be exchanged for definitive debt securities of that series in registered form.

Each person having an ownership or other interest in a debt security must rely exclusively on the rules or procedures of the depository as the case may be, and any agreement with any direct or indirect participant of the depository, including Euroclear or Clearstream Luxembourg and their participants, as applicable, or any other securities intermediary through which that person holds its interest, to receive or direct the delivery of possession of any definitive security. The indentures permit us to determine at any time and in our sole discretion that debt securities shall no longer be represented by global securities. DTC has advised us that, under its current practices, it would notify its participants of our request, but will only withdraw beneficial interests from the global securities at the request of each DTC participant. We would issue definitive certificates in exchange for any such beneficial interests withdrawn.

Unless otherwise specified in the prospectus supplement, definitive debt securities will be issued in registered form only. To the extent permitted by law, we, the trustee and any paying agent shall be entitled to treat the person in whose name any definitive security is registered as its absolute owner.

Payments in respect of each series of definitive securities will be made to the person in whose name the definitive securities are registered as it appears in the register for that series of debt securities. Payments will be made in respect of the debt securities by check drawn on a bank in New York or, if the holder requests, by transfer to the holder's account in New York. Definitive securities should be presented to the paying agent for redemption.

If we issue definitive debt securities of a particular series in exchange for a particular global debt security, the depository, as holder of that global debt security, will surrender it against receipt of the definitive debt securities, cancel the book-entry debt securities of that series, and distribute the definitive debt securities of that series to the persons and in the amounts that the depository specifies pursuant to the internal procedures of such depository.

If definitive securities are issued in the limited circumstances described above, those securities may be transferred in whole or in part in denominations of any whole number of securities upon surrender of the definitive securities certificates together with the form of transfer endorsed on it, duly completed and executed at the specified office of a

paying agent. If only part of a securities certificate is transferred, a new securities certificate representing the balance not transferred will be issued to the transferor within three business days after the paying agent receives the certificate. The new certificate representing the balance will be delivered to the transferor by uninsured post at the risk of the transferor, to the address of the transferor appearing in the records of the paying agent. The new certificate representing the securities that were transferred will be sent to the transferee within three business days after the paying agent receives the certificate transferred, by uninsured post at the risk of the holder entitled to the securities represented by the certificate, to the address specified in the form of transfer.

Settlement

Initial settlement for each series of debt securities and settlement of any secondary market trades in the debt securities will be made in same-day funds. Book-entry debt securities held through DTC will settle in DTC's Same-Day Funds Settlement System.

Payments

We will make any payments of interest and principal, on any particular series of debt securities on the dates and, in the case of payments of interest, at the rate or rates, that we set out in, or that are determined by the method of calculation described in, the relevant prospectus supplement.

Subordinated Debt Securities

We are not required to make payments of interest and principal on the subordinated debt securities and if we fail to make a payment, our obligation to make such payments shall be deferred and such failure to make a payment does not create a default under the applicable subordinated debt indenture. The relevant prospectus supplement will set forth the terms on which the payment of interest and principal on the subordinated debt securities can be deferred and any other terms relating to payments on subordinated debt securities.

Capital Securities

We are not required to make payments on any series of capital securities on any payment date and if we fail to make a payment, such failure shall not create a default under the capital securities indenture. Unless the relevant prospectus supplement provides otherwise, any payment that we do not make in respect of any series of capital securities on any applicable payment date, together with any other unpaid payments, so long as they remain unpaid, shall be missed payments and will accumulate until paid. The relevant prospectus supplement will set forth the terms on which all payments, including missed payments, on the capital securities of a particular series outstanding at the time will be treated, including deferral.

Subordination

Senior Debt Securities

Unless the relevant prospectus supplement provides otherwise, senior debt securities constitute our direct, unconditional, unsecured and unsubordinated obligations ranking *pari passu*, without any preference among themselves, with all of our other outstanding unsecured and unsubordinated obligations, present and future, except such obligations as are preferred by operation of law.

Subordinated Debt Securities

Unless the relevant prospectus supplement provides otherwise, in a winding up, all payments on any series of subordinated debt securities will be subordinate to, and subject in right of payment to the prior payment in full of, all claims of all of our creditors other than claims in respect of any liability that is, or is expressed to be, subordinated, whether only in the event of a winding up or otherwise, to the claims of all or any of our creditors, in the manner provided in the applicable subordinated debt indenture.

Capital Securities

Unless the relevant prospectus supplement provides otherwise, in a winding up, the principal amount of, and payments and any missed payments on, any series of capital securities will be subordinate to, and subject in right of payment to the prior payment in full of, all Senior Claims. The following are “Senior Claims” in respect of any series of capital securities:

- all claims of our unsubordinated creditors admitted in the winding up;
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- all claims of our creditors in respect of liabilities that are, or are expressed to be, subordinated, whether only in the event of a winding up or otherwise, to the claims of our unsubordinated creditors but not further or otherwise; and
- all other claims except those that rank, or are expressed to rank, equally with or junior to the claims of any holder of capital securities of any series.

Additional senior claims, if any, may be set forth in the accompanying prospectus supplement.

Unless the relevant prospectus supplement provides otherwise, if at any time an order is made or a shareholders' resolution is passed for a winding up, any amounts that would have been payable in respect of the capital securities of any series if, on and after the day immediately before the winding up began, any holder of those capital securities had been the holder of preference shares in our capital with a preferential right to a return of assets in the winding up over the holders of all other issued shares, including all classes of our preference shares, will be payable on those capital securities. These amounts will be calculated assuming that such preference shares were entitled, to the exclusion of all other rights or privileges, to receive as a return of capital an amount equal to the principal amount of the capital securities of the series then outstanding, together with all payments accrued to the date of repayment at the rate provided for in those capital securities and any missed payments. Accordingly, no amount will be payable in a winding up on any series of capital securities until all Senior Claims admitted in the winding up have been paid in full.

General

As a consequence of these subordination provisions, if winding up proceedings should occur, each holder may recover less ratably than the holders of our unsubordinated liabilities and, in the case of the holders of capital securities, the holders of certain of our subordinated liabilities, including the holders of subordinated debt securities. If, in any winding up, the amount payable on any series of debt securities and any claims ranking equally with that series are not paid in full, those debt securities and other claims ranking equally will share ratably in any distribution of our assets in a winding up in proportion to the respective amounts to which they are entitled. If any holder is entitled to any recovery with respect to the debt securities in any winding up or liquidation, the holder might not be entitled in those proceedings to a recovery in U.S. dollars and might be entitled only to a recovery in pounds sterling or any other lawful currency of the United Kingdom.

In addition, because RBSG is a holding company, its rights to participate in the assets of any subsidiary if it is liquidated will be subject to the prior claims of its creditors, including, in the case of RBS plc, RBS plc's depositors, except to the extent that RBSG may be a creditor with recognized claims against RBS plc.

Additional Amounts

Unless the relevant prospectus supplement provides otherwise, we will pay any amounts to be paid by us on any series of debt securities without deduction or withholding for, or on account of, any and all present and future income, stamp and other taxes, levies, imposts, duties, charges, fees, deductions or withholdings imposed, levied, collected, withheld or assessed by or on behalf of the United Kingdom or any U.K. political subdivision thereof or authority that has the power to tax (a "U.K. taxing jurisdiction"), unless such deduction or withholding is required by law. If at any time a U.K. taxing jurisdiction requires us to make such deduction or withholding, we will pay additional amounts with respect to the principal of, and payments and missed payments on, the debt securities ("Additional Amounts") that are necessary in order that the net amounts paid to the holders of those debt securities, after the deduction or withholding, shall equal the amounts of principal and any payments and missed payments which would have been payable on that series of debt securities if the deduction or withholding had not been required. However, this will not apply to any tax that would not have been payable or due but for the fact that:

- the holder or the beneficial owner of the debt securities is a domiciliary, national or resident of, or engaging in business or maintaining a permanent establishment or physically present in, a U.K. taxing jurisdiction or otherwise having some connection with the U.K. taxing jurisdiction other than the holding or ownership of a debt security, or the collection of any payment of, or in respect of, principal of, or any payments or missed payments on, any debt security of the relevant series;
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- except in the case of a winding up in the United Kingdom, the relevant debt security is presented (where presentation is required) for payment in the United Kingdom;
- the relevant debt security is presented (where presentation is required) for payment more than 30 days after the date payment became due or was provided for, whichever is later, except to the extent that the holder would have been entitled to the Additional Amounts on presenting the debt security for payment at the close of that 30 day period;
- the holder or the beneficial owner of the relevant debt security or the beneficial owner of any payment of or in respect of principal of, or any payments or missed payments on, the debt security failed to comply with a request by us or our liquidator or other authorized person addressed to the holder to provide information concerning the nationality, residence or identity of the holder or the beneficial owner or to make any declaration or other similar claim to satisfy any information requirement, which is required or imposed by a statute, treaty, regulation or administrative practice of a U.K. taxing jurisdiction as a precondition to exemption from all or part of the tax;
- the withholding or deduction is imposed on a payment to or for the benefit of an individual and is required to be made pursuant to, in the case of capital securities and senior debt securities, European Council Directive 2003/48/EC or any other Directive implementing the conclusions of the ECOFIN Council meeting of November 26-27, 2000 on the taxation of savings income or any law implementing or complying with, or introduced in order to conform to, such directive or, in the case of subordinated debt securities, any European Union Directive on the taxation of savings implementing the proposal for a European Union Directive presented by the European Commission on July 18, 2001 or any law implementing or complying with, or introduced in order to conform to, such a directive;
- the relevant debt security is presented (where presentation is required) for payment by or on behalf of a holder who would have been able to avoid such withholding or deduction by presenting the relevant debt security to another paying agent in a Member State of the European Union; or
 - any combination of the above items;

nor shall Additional Amounts be paid with respect to the principal of, and payments and missed payments on, the debt securities to any holder who is a fiduciary or partnership or settlor with respect to such fiduciary or a member of such partnership other than the sole beneficial owner of such payment to the extent such payment would be required by the laws of any taxing jurisdiction to be included in the income for tax purposes of a beneficiary or partner or settlor with respect to such fiduciary or a member of such partnership or a beneficial owner who would not have been entitled to such Additional Amounts, had it been the holder.

Whenever we refer in this prospectus and any prospectus supplement, in any context, to the payment of the principal of or any payments, or any missed payments on, or in respect of, any debt security of any series, we mean to include the payment of Additional Amounts to the extent that, in the context, Additional Amounts are, were or would be payable.

Redemption

Unless the relevant prospectus supplement provides otherwise, we will, and in the case of capital securities only if the solvency condition is satisfied, have the option to redeem the debt securities of any series as a whole upon (i) not less than 5 business days and not more than 60 calendar days' notice in respect of subordinated debt securities issued by RBS plc and senior debt securities, including Series A Senior Notes, issued by RBSG or (ii) not less than 30 days and not more than 60 days' notice in respect of capital securities issued by RBSG, subordinated debt securities issued by

RBSG and senior debt securities, including RBS NotesSM and Retail Corporate Notes, issued by RBS plc, to each holder of debt securities, on any payment date, at a redemption price equal to 100% of their principal amount together with any accrued but unpaid payments of interest, if any (including any deferred amounts, if applicable) in the case of senior debt securities and subordinated debt securities, and all payments and missed payments in the case of capital securities, to the redemption date, or, in the case of discount securities, their accreted face amount, together with any accrued interest, if, at any time, we determine that as a result of a change in or amendment to the laws or regulations of a U.K. taxing jurisdiction, including any treaty to which it is a party, or a

change in an official application or interpretation of those laws or regulations, including a decision of any court or tribunal, which becomes effective on or after the date of the applicable prospectus supplement:

- in making any payments, including missed payments in the case of capital securities, on the particular series of debt securities, we have paid or will or would on the next payment date be required to pay Additional Amounts;

Total	
\$	35,294
\$	28,878

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Concentration of Market and Credit Risk The following table identifies certain of the Company's products, defined as generics containing the same active ingredient or combination of ingredients, which accounted for greater than 10% of net sales in either of the three month periods ended September 30, 2012 and 2011, respectively.

	2012	2011
Product 1	39%	45%
Product 2	10%	9%
Product 3	10%	
Product 4	8%	12%

The following table identifies certain of the Company's customers which accounted for greater than 10% of net sales in either of the three month periods ended September 30, 2012 and 2011, respectively.

	2012	2011
Customer A	17%	21%
Customer B	11%	12%
Customer C	10%	9%
Customer D	10%	11%

At September 30, 2012 and 2011, four customers accounted for 67% and 71% of the Company's accounts receivable balances, respectively. Credit terms are offered to customers based on evaluations of the customers' financial condition. Generally, collateral is not required from customers. Accounts receivable payment terms vary and are stated in the financial statements at amounts due from customers net of an allowance for doubtful accounts. Accounts remaining outstanding longer than the payment terms are considered past due. The Company determines its allowance by considering a number of factors, including the length of time trade accounts receivable are past due, the Company's previous loss history, the customer's current ability to pay its obligation to the Company, and the condition of the general economy and the industry as a whole. The Company writes-off accounts receivable when they are determined to have become uncollectible.

Share-based Compensation - Share-based compensation costs are recognized over the vesting period based on the fair value of the instrument on the date of grant less an estimate for forfeitures. The Company uses the Black-Scholes valuation model to determine the fair value of stock options and the share price on the grant date to value restricted stock. The fair value model includes various assumptions, including the expected volatility, expected life of the awards, and risk-free interest rates. These assumptions involve inherent uncertainties based on market conditions which are generally outside the Company's control. Changes in these assumptions could have a material impact on share-based compensation costs recognized in the financial statements.

Note 3. New Accounting Standards

In June 2011, the FASB issued authoritative guidance which allows an entity the option to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In both options, an entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for

comprehensive income. This guidance eliminates the option to present the components of other comprehensive income as part of the statement of changes in stockholders' equity. This guidance does not change the items that must be reported in other comprehensive income or when an item of other comprehensive income must be reclassified to net income. This authoritative guidance must be applied retrospectively, and is effective for fiscal years and interim periods within those years, beginning after December 15, 2011. In December 2011, the FASB issued an update deferring the effective date for amendments to the presentation of reclassifications of items out of accumulated other comprehensive income. The adoption of this guidance by the Company on July 1, 2012 did not have a significant impact on the Company's consolidated financial statements as it only requires a change in the format of the presentation.

In July 2012, the FASB issued authoritative guidance which allows an entity the option to first assess qualitative factors to determine whether the existence of events and circumstances indicates that it is more likely than not that an indefinite-lived intangible asset is impaired. If, after assessing the totality of events and circumstances, an entity concludes that it is not more likely than not that the indefinite-lived intangible asset is impaired, then the entity is not required to take further action. An entity also has the option to bypass the qualitative assessment for any indefinite-lived intangible asset in any period and proceed directly to performing the quantitative impairment test. An entity will be able to resume performing the qualitative assessment in any subsequent period. The amendments are effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012.

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Early adoption is permitted, including for annual and interim impairment tests performed as of a date before July 27, 2012, if a public entity's financial statements for the most recent annual or interim period have not yet been issued or, for nonpublic entities, have not yet been made available for issuance. The Company adopted this guidance effective July 1, 2012. The adoption of this guidance by the Company did not have a significant impact on the Company's consolidated financial statements.

Note 4. Inventories

Inventories at September 30, 2012 and June 30, 2012 consist of the following:

(In thousands)	September 30, 2012	June 30, 2012
Raw Materials	\$ 11,648	\$ 11,351
Work-in-process	6,336	4,805
Finished Goods	7,875	9,130
Packaging Supplies	1,747	1,778
	\$ 27,606	\$ 27,064

The preceding amounts are net of excess and obsolete inventory reserves of \$1,564 and \$1,472 at September 30, 2012 and June 30, 2012, respectively.

Recently, the FDA increased its efforts to force companies to file and seek FDA approval for GRASE or Grandfathered products. GRASE products are those old drugs that do not require prior approval from FDA in order to be marketed because they are generally recognized as safe and effective based on published scientific literature. Similarly, Grandfathered products are those which entered the market before the passage of the 1906 Act, the 1938 Act or the 1962 amendments to the Act. Efforts have included issuing notices to discontinue marketing certain products to companies currently producing these products. Lannett currently manufactures and markets several products that are considered GRASE or Grandfathered products, including C-Topical Solution and Oxycodone HCl Oral Solution. The FDA is currently undertaking activities to force all companies who manufacture such products to file applications and seek approval for these types of products or remove them from the market. The Company had approximately \$942 and \$1,703 of net inventory value of other Grandfathered products at September 30, 2012 and June 30, 2012, respectively.

Note 5. Property, Plant and Equipment

Property, plant and equipment at September 30, 2012 and June 30, 2012 consist of the following:

(In thousands)	Useful Lives	September 30, 2012	June 30, 2012
Land		\$ 1,350	\$ 1,350
Building and improvements	10 - 39 years	28,686	28,420

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Machinery and equipment	5 - 10 years	32,741	32,322
Furniture and fixtures	5 - 7 years	1,261	1,247
Construction in progress		2,199	2,159
		66,237	65,498
Less accumulated depreciation		(29,426)	(28,430)
Property, plant and equipment, net		\$ 36,811	\$ 37,068

At September 30, 2012 and June 30, 2012, Property, plant and equipment, net included amounts held in foreign countries in the amount of \$1,156 and \$1,239, respectively.

Note 6. Fair Value Measures

The Company follows the authoritative guidance which clarifies the definition of fair value, establishes a framework for measuring fair value, and expands the disclosures on fair value measurements. Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. The authoritative guidance also establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. Three levels of inputs were established that may be used to measure fair value:

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Level 1 Quoted prices in active markets for identical assets or liabilities. The fair value of the Company's equity securities classified as trading securities in Note 7 below are derived solely from Level 1 inputs.

Level 2 Observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices for identical or similar instruments in markets that are not active; or model-derived valuations whose inputs are observable or whose significant value drivers are observable. The Company's Level 2 assets and liabilities primarily include debt securities with quoted prices that are traded less frequently than exchange-traded instruments, corporate bonds, U.S. government and agency securities and certain mortgage-backed and asset-backed securities whose values are determined using pricing models with inputs that are observable in the market or can be derived principally from or corroborated by observable market data. The Company did not have any Level 2 assets or liabilities as of September 30, 2012 or June 30, 2012.

Level 3 Unobservable inputs that are supported by little or no market activity and that are financial instruments whose values are determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant judgment or estimation. The Company did not have any Level 3 assets or liabilities as of September 30, 2012 or June 30, 2012.

If the inputs used to measure the financial assets and liabilities fall within more than one level described above, the categorization is based on the lowest level input that is significant to the fair value measurement of the instrument.

The carrying value of certain financial instruments, primarily cash and cash equivalents, accounts receivable, accounts payable, and accrued expenses approximate their estimated fair values based upon the short-term nature of these instruments. The carrying amount of the Company's debt obligations approximates fair value based on current rates available to the Company on similar debt obligations.

Note 7. Investment Securities

The amortized cost, gross unrealized gains and losses, and fair value of the Company's investment securities as of September 30, 2012 and June 30, 2012:

September 30, 2012

(In thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
<u>Trading</u>				
Equity securities	\$ 4,947	\$ 195	\$ (132)	\$ 5,010

June 30, 2012

(In thousands)	Amortized Cost		Gross Unrealized Gains		Gross Unrealized Losses		Fair Value
<u>Trading</u>							
Equity securities	\$	6,874	\$	157	\$	(364)	\$ 6,667

The Company uses the specific identification method to determine the cost of securities sold. For the three months ended September 30, 2012 the Company had gains on investments of \$234, of which \$36 were realized losses and \$270 were unrealized gains. For the three months ended September 30, 2011, the Company had losses on investments of \$999, of which \$173 were realized losses and \$826 were unrealized losses.

As of September 30, 2012 and June 30, 2012, there were no securities held from a single issuer that represented more than 10% of shareholders equity. As of September 30, 2012, securities with an aggregate fair value of \$2,294 were in an unrealized loss position totaling \$132. As of June 30, 2012, securities with an aggregate fair value of \$3,466 were in an unrealized loss position totaling \$364. Of those securities in an unrealized loss position at September 30, 2012, \$96 were in a continuous unrealized loss position for more than 12 months with a total unrealized loss of \$14. No securities were in a continuous unrealized loss position for more than 12 months as of June 30, 2012.

Table of Contents**Note 8. Other Assets**

As of July 24, 2010, Lannett stopped manufacturing and distributing Morphine Sulfate Oral Solution (MS). Lannett filed a 5(15) (2) New Drug Application (MS NDA) in February 2010 and received FDA approval on the submission in June 2011. The filing fee related to this application totaled \$1,406 and was initially recorded within other current assets on the consolidated balance sheets because part of or the entire fee was thought to be refundable. Lannett met with the FDA in January 2011 to review the status of the application. At that time, the FDA stated that it will need to finalize its Establishment Inspection Report for the February 2011 inspection of Lannett's facilities before it could give final approval on the MS NDA. Additionally, the Company corresponded with the FDA in March 2011 regarding whether any of the fee is refundable. The FDA's response was that the entire filing fee was not refundable. In September 2012, the Company had further communications with the FDA regarding the refundable portion of the filing fee. Based on these communications, the Company continues to believe that a portion of the filing fee is refundable. As of September 30, 2012, the Company has not been refunded any portion of the filing fee, nor has the Company received final determination on whether any of the fee is refundable.

The Company's position is that the value related to the part of the fee that is not refunded is the cost of getting regulatory approval for its MS product and that this value should be properly recorded as an intangible asset based upon approval and amortized over the product's estimated useful life upon shipment of the product. The revenues and gross profit margins attained by the Company from sales of its MS product currently substantiate its value as an intangible asset. As a result of the FDA approval of the MS NDA, an estimate of the nonrefundable amount totaling \$398 determined, based upon input from a third party analysis, was reclassified to intangible assets upon shipment of the product which commenced in August 2011. Amortization will be adjusted prospectively once the nonrefundable portion of the fee is finalized with the FDA.

Note 9. Intangible Assets

Intangible assets, net as of September 30, 2012 and June 30, 2012, consist of the following:

(In thousands)	Gross Carrying Amount		Accumulated Amortization		Intangible Assets, Net	
	September 30, 2012	June 30, 2012	September 30, 2012	June 30, 2012	September 30, 2012	June 30, 2012
JSP Marketing and Dist. Rights	\$ 16,062	\$ 16,062	\$ (13,385)	\$ (12,939)	\$ 2,677	\$ 3,123
Cody Labs Import License	582	582	(163)	(154)	419	428
Morphine Sulfate Oral Solution NDA	398	398	(31)	(24)	367	374
Other ANDA Product Rights(A)	600	600	(105)	(96)	495	504
	\$ 17,642	\$ 17,642	\$ (13,684)	\$ (13,213)	\$ 3,958	\$ 4,429

(A) The amounts above include the product line covered by the ANDA's purchased in August 2009 for \$149. These ANDA's are not being amortized at this time and will continue to be un-amortized intangible assets until such time as the Company begins shipping these products.

The following table summarizes intangible assets, net activity

(In thousands)	Intangible assets, net	
Balances at July 1, 2012	\$	4,429
Additions		
Amortization		(471)
Impairments		
Balances at September 30, 2012	\$	3,958

There were no impairments related to intangible assets during the three months ended September 30, 2012 or the fiscal year ended June 30, 2012.

For the three months ended September 30, 2012 and 2011, the Company incurred amortization expense of approximately \$471 and \$468, respectively.

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Future annual amortization expense consists of the following as of September 30, 2012:

(In thousands)	
Fiscal Year Ending June 30,	Annual Amortization Expense
2013	\$ 1,411
2014	1,435
2015	97
2016	97
2017	97
Thereafter	672
	\$ 3,809

The amounts above do not include the product line covered by the ANDAs purchased in August 2009 for \$149, as amortization will begin when the Company starts shipping these products.

Note 10. Bank Line of Credit

The Company has a \$3,000 line of credit from Wells Fargo Bank, N.A. (Wells Fargo) that was scheduled to expire on March 31, 2012. The line of credit was renewed and extended until April 30, 2013 and bears interest of 1-month LIBOR Market Index Rate plus 2.00%. The interest rate at September 30, 2012 and June 30, 2012 was 2.21% and 2.22%. Availability under the line of credit is reduced by outstanding letters of credit. As of September 30, 2012 and June 30, 2012, the Company had \$3,000 and \$2,995 of availability under the line of credit, respectively. The availability fee on the unused balance of the line of credit is 0.375%. The line of credit is collateralized by the working capital assets of the Company. As of September 30, 2012, the Company was in compliance with the financial covenants under the agreement.

Note 11. Long-Term Debt

Long-term debt consists of the following:

(In thousands)	September 30, 2012	June 30, 2012
Pennsylvania Industrial Development Authority loan	\$ 757	\$ 777
Tax-exempt bond loan (PAID)	290	290
Wells Fargo N.A. Townsend Road mortgage	2,767	2,818
PIDA Townsend Road mortgage	1,873	1,899
First National Bank of Cody mortgage	1,349	1,377
Total debt	7,036	7,161
Less current portion	651	648
Long term debt	\$ 6,385	\$ 6,513

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Current Portion of Long Term Debt

	September 30, 2012		June 30, 2012
Pennsylvania Industrial Development Authority loan	\$	82	\$ 81
Tax-exempt bond loan (PAID)		140	140
Wells Fargo N.A. Townsend Road mortgage		204	204
PIDA Townsend Road mortgage		106	105
First National Bank of Cody mortgage		119	118
Total current portion of long term debt	\$	651	\$ 648

The Company financed \$1,250 through the Pennsylvania Industrial Development Authority (PIDA). The Company is required to make equal payments each month for 180 months starting February 1, 2006 with interest of 2.75% per annum.

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In April 1999, the Company entered into a loan agreement with a governmental authority, the Philadelphia Authority for Industrial Development (the Authority or PAID), to finance future construction and growth projects of the Company. The Authority issued \$3,700 in tax-exempt variable rate demand and fixed rate revenue bonds to provide the funds to finance such growth projects pursuant to a trust indenture (the Trust Indenture). A portion of the Company's proceeds from the bonds was used to pay for bond issuance costs of approximately \$170. The Trust Indenture requires that the Company repay the Authority loan through installment payments beginning in May 2003 and continuing through May 2014, the year the bonds mature. The bonds bear interest at the floating variable rate determined by the organization responsible for selling the bonds. The interest rate fluctuates on a weekly basis. The effective interest rate at September 30, 2012 and June 30, 2012 was 0.39% and 0.38%, respectively.

During the third and fourth quarters of Fiscal 2011, the Company negotiated a set of mortgages on its Townsend Road facility with both Wells Fargo and the PIDA. The Wells Fargo portion of the loan is for \$3,056, bears a floating interest rate of the 1 Month LIBOR rate plus 2.95%, amortizes over a 15 year term and has an 8 year maturity date. The effective interest rate at September 30, 2012 and June 30, 2012 was 3.16% and 3.20%, respectively. The PIDA portion of the loan is for \$2,000, bears an interest rate of 3.75% and matures in 15 years. Both loans closed and were funded in May 2011. As of September 30, 2012 and June 30, 2012, the Company was in compliance with the new financial covenants under the agreements.

The Company has executed Security Agreements with Wells Fargo, PIDA and PIDC in which the Company has agreed to pledge its working capital, some equipment and its Townsend Road property to collateralize the amounts due.

The Company is the primary beneficiary to a variable interest entity (VIE) called Cody LCI Realty, LLC. See Note 12, Consolidation of Variable Interest Entity for additional description. The VIE owns land and a building which is being leased to Cody. A mortgage loan with First National Bank of Cody has been consolidated in the Company's financial statements, along with the related land and building. The mortgage requires monthly principal and interest payments of \$15. Effective February 2011, the interest rate was modified from a fixed rate of 7.5% to a floating rate with a floor of 4.5% and a ceiling of 9.0%, with payments to be made through April 2022. As of September 30, 2012 and June 30, 2012, the effective rate was 4.5%. The mortgage is collateralized by the land and building.

Long-term debt amounts due, for the twelve month periods ending September 30 are as follows:

(In thousands)	Amounts Payable to Institutions
2013	\$ 651
2014	673
2015	535
2016	548
2017	562
Thereafter	4,067
	\$ 7,036

Note 12. Consolidation of Variable Interest Entity

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Lannett consolidates any Variable Interest Entity (VIE) of which it is the primary beneficiary. The liabilities recognized as a result of consolidating a VIE do not represent additional claims on the Company's general assets rather, they represent claims against the specific assets of the consolidated VIE. Conversely, assets recognized as a result of consolidating a VIE do not represent additional assets that could be used to satisfy claims against our general assets. Reflected in each of the September 30, 2012 and June 30, 2012 balance sheets are consolidated VIE assets of approximately \$1,761 and \$1,757, respectively, which are comprised mainly of land and a building. VIE liabilities consist primarily of a mortgage on that property in the amount of \$1,349 and \$1,377 at September 30, 2012 and June 30, 2012, respectively.

Cody LCI Realty LLC (Realty) is the only VIE that is consolidated. Realty had been consolidated by Cody prior to its acquisition by Lannett. Realty is a 50/50 joint venture with an officer of Cody Labs. Its purpose was to acquire the facility used by Cody. Until the acquisition of Cody in April 2007, Lannett had not consolidated the VIE because Cody had been the primary beneficiary of the VIE. Risk associated with our interests in this VIE is limited to a decline in the value of the land and building as compared to the balance of the mortgage note on that property, up to Lannett's 50% share of the venture. Realty owns the land and building, and Cody leases the building and property from Realty for \$20 per month. All intercompany rent expense is eliminated upon consolidation with Cody. The Company is not involved in any other VIE.

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Note 13. Contingencies

In January 2010, the Company initiated an arbitration proceeding against Olive Healthcare (Olive) for damages arising out of Olive 's delivery of defective soft-gel prenatal vitamin capsules. The Company sought damages in excess of \$3,500. Olive denied liability and filed a counterclaim in February 2010 for breach of contract. Olive also filed a lawsuit against the Company in Daman, India seeking to enjoin the United States arbitration and claiming damages of approximately \$6,800 for compensatory damages and an additional approximately \$6,800 for loss of business. The Company engaged Indian counsel and actively defended that suit. The parties reached a settlement agreement which was signed and executed on August 13, 2012. The agreement is favorable to Lannett and includes the dismissal with prejudice of all legal proceedings between the Company and Olive in the U.S. and India. As of September 30, 2012, the Company had recorded all amounts related to the agreement.

Note 14. Commitments

Leases

Lannett 's subsidiary, Cody leases a 73 square foot facility in Cody, Wyoming. This location houses Cody 's manufacturing and production facilities. Cody leases the facility from Cody LCI Realty, LLC, a Wyoming limited liability company which is 50% owned by Lannett. See Note 12.

Rental and lease expense for the three months ended September 30, 2012 and 2011 was approximately \$24 and \$28, respectively.

Employment Agreements

The Company has entered into employment agreements with Arthur P. Bedrosian, President and Chief Executive Officer, Martin P. Galvan, Vice President of Finance, Chief Financial Officer and Treasurer, Kevin R. Smith, Vice President of Sales and Marketing, William F. Schreck, Chief Operating Officer, Ernest J. Sabo, Vice President of Regulatory Affairs and Chief Compliance Officer and Robert Ehlinger, Vice President of Logistics and Chief Information Officer. Each of the agreements provide for an annual base salary and eligibility to receive a bonus. The salary and bonus amounts of these executives are determined by the review and approval of the Compensation Committee in accordance with the Committee 's Charter as approved by the Board of Directors. Additionally, these executives are eligible to receive stock options and restricted stock awards, which are granted at the discretion of the Compensation Committee in accordance with the Committee 's Charter as approved by the Board of Directors and in accordance with the Company 's policies regarding stock option and restricted stock grants. Under the agreements, these executive employees may be terminated at any time with or without cause, or by reason of death or disability. In certain termination situations, the Company is liable to pay severance compensation to these executives of between 18 months and three years.

Note 15. Accumulated Comprehensive Loss

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The Company's Accumulated Comprehensive Loss is comprised of the following components as of September 30, 2012 and 2011:

(In thousands)	September 30, 2012	September 30, 2011
Foreign Currency Translation		
Beginning Balance	\$ (63)	\$ 22
Net gain (loss) on foreign currency translation (net of tax of \$0 and \$0)	41	(3)
Reclassifications to net income (net of tax of \$0 and \$0)		
Other Comprehensive income (loss), net of tax	41	(3)
Ending Balance	(22)	19
Unrealized Holding Gain (Loss)		
Beginning Balance	\$	\$ 2
Net unrealized holding gain (loss) (net of tax of \$0 and \$1)		(1)
Reclassifications to net income (net of tax of \$0 and \$0)		
Other comprehensive income (loss), net of tax		(1)
Ending Balance		1
Total Accumulated Other Comprehensive Loss	\$ (22)	\$ 20

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A dual presentation of basic and diluted earnings per common share is required on the face of the Company's consolidated statement of operations as well as a reconciliation of the computation of basic earnings per common share to diluted earnings per common share. Basic earnings per common share excludes the dilutive impact of common stock equivalents and is computed by dividing net income by the weighted-average number of shares of common stock outstanding for the period. Diluted earnings per common share include the effect of potential dilution from the exercise of outstanding common stock equivalents into common stock using the treasury stock method. Dilutive shares have been excluded in the weighted average shares used for the calculation of earnings per share in periods of net loss because the effect of such securities would be anti-dilutive. A reconciliation of the Company's basic and diluted earnings per common share follows:

(In thousands, except share and per share data)	For The Three Months Ended September 30,	
	2012	2011
Net Income attributable to Lannett common shareholders	\$ 2,926	\$ 206
Weighted average common shares outstanding (basic)	28,278,514	28,431,733
Effect of potentially dilutive options and restricted stock awards	190,710	254,911
Weighted average common shares outstanding (diluted)	28,469,224	28,686,644
Basic earnings per common share	\$ 0.10	\$ 0.01
Diluted earnings per common share	\$ 0.10	\$ 0.01

The number of anti-dilutive shares that have been excluded in the computation of diluted earnings per share for the three months ended September 30, 2012 and 2011 were 2,017 and 1,575, respectively.

Note 17. Share-based Compensation

At September 30, 2012, the Company had four share-based employee compensation plans (the Old Plan, the 2003 Plan, the 2006 Long-term Incentive Plan, or 2006 LTIP and the 2011 Long-Term Incentive Plan or 2011 LTIP).

At September 30, 2012, there were 2,610 options outstanding. Of those, 1,565 were options issued under the 2006 LTIP, 862 were issued under the 2003 Plan, and 183 under the Old Plan. There are no further shares authorized to be issued under the Old Plan. Under the 2003 Plan, 1,125 shares were authorized to be issued, with 60 shares under options having already been exercised under that plan since its inception, leaving a balance of 203 shares in that plan for future issuances. Under the 2006 LTIP, 2,500 shares were authorized to be issued, with 190 shares under options having already been exercised under that plan since its inception. At September 30, 2012, there were 73 nonvested restricted shares outstanding which were issued under the 2006 LTIP, with 635 shares having already vested under that plan since its inception. At September 30, 2012, a balance of 37 shares is available in the 2006 LTIP for future issuances. Under the 2011 LTIP, 1,500 shares were authorized to be issued. As of September 30, 2012, 3 shares of restricted stock have vested under the plan, leaving a balance of 1,497 shares available in the 2011 LTIP for future issuances.

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The following tables presents all share-based compensation costs recognized in our statements of income, substantially all of which is reflected in the selling, general and administrative expense line:

(In thousands)	Three months ended September 30,	
	2012	2011
Share-based compensation		
Stock options	\$ 315	\$ 389
Employee stock purchase plan	\$ 27	\$ 9
Restricted stock	\$ 314	\$ 273
Tax benefit at statutory rate	\$ 23	\$ 38

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The Company measures share-based compensation cost for options using the Black-Scholes option pricing model. The following table presents the weighted average assumptions used to estimate fair values of the stock options granted during the three months ended September 30 and the estimated annual forfeiture rates used to recognize the associated compensation expense:

	Incentive Stock Options FY 2013	Non- qualified Stock Options FY 2013	Incentive Stock Options FY 2012	Non- qualified Stock Options FY 2012
Risk-free interest rate	%	%	0.3%	0.1%
Expected volatility	%	%	63.6%	63.9%
Expected dividend yield	%	%	%	%
Forfeiture rate	%	%	7.50%	7.50%
Expected term (in years)			5.2 years	5.1 years
Weighted average fair value	\$	\$	\$ 1.99	\$ 1.94

Expected volatility is based on the historical volatility of the price of our common shares during the historical period equal to the expected term of the option. We use historical information to estimate expected term within the valuation model. The expected term of awards represents the period of time that options granted are expected to be outstanding. The risk-free rate for periods within the expected life of the option is based on the U.S. Treasury yield curve in effect at the time of grant. Compensation cost is recognized using a straight-line method over the vesting or service period and is net of estimated forfeitures.

The forfeiture rate assumption is the estimated annual rate at which unvested awards are expected to be forfeited during the vesting period. This assumption is based on our historical forfeiture rate. Periodically, management will assess whether it is necessary to adjust the estimated rate to reflect changes in actual forfeitures or changes in expectations.

Options outstanding that have vested and are expected to vest as of September 30, 2012 are as follows:

(In thousands, except weighted average price and life data)	Awards	Weighted Average Exercise Price	Aggregate Intrinsic Value	Weighted Average Remaining Contractual Life (yrs.)
Options vested	1,872	\$ 7.23	\$ 768	4.74
Options expected to vest	679	\$ 4.55	\$ 561	8.44
Total vested and expected to vest	2,551	\$ 6.51	\$ 1,329	5.73

Options with a fair value of approximately \$540 and \$206 vested during the three months ended September 30, 2012 and 2011, respectively.

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A summary of stock option award activity under the Plans as of September 30, 2012 and 2011 and changes during the three months then ended, is presented below:

(In thousands, except for weighted average price and life data)	Incentive Stock Options				Nonqualified Stock Options			
	Awards	Weighted-Average Exercise Price	Aggregate Intrinsic Value	Weighted Average Remaining Contractual Life (yrs.)	Awards	Weighted-Average Exercise Price	Aggregate Intrinsic Value	Weighted Average Remaining Contractual Life (yrs.)
Outstanding at July 1, 2012	1,871	\$ 5.26	\$		877	\$ 8.89		
Granted		\$				\$		
Exercised	(44)	\$ 4.06	\$ 35			\$	\$	
Forfeited, expired or repurchased	(73)	\$ 6.40			(21)	\$ 7.23		
Outstanding at September 30, 2012	1,754	\$ 5.24	\$ 1,127	6.7	856	\$ 8.93	\$ 266	4.0
Outstanding at September 30, 2012 and not yet vested	695	\$ 4.42	\$ 603	8.5	43	\$ 5.59	\$ 22	7.8
Exercisable at September 30, 2012	1,059	\$ 5.78	\$ 524	5.5	813	\$ 9.11	\$ 244	3.8

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(In thousands, except for weighted average price and life data)	Incentive Stock Options					Nonqualified Stock Options			
	Awards	Weighted-Average Exercise Price	Aggregate Intrinsic Value	Weighted Average Remaining Contractual Life (yrs.)	Awards	Weighted-Average Exercise Price	Aggregate Intrinsic Value	Weighted Average Remaining Contractual Life (yrs.)	
Outstanding at July 1, 2011	1,196	\$ 6.19			749	\$ 9.77			
Granted	702	\$ 3.52			119	\$ 3.65			
Exercised		\$	\$			\$	\$		
Forfeited, expired or repurchased	(11)	\$ 5.66				\$			
Outstanding at September 30, 2011	1,887	\$ 5.20	\$ 396	7.6	868	\$ 8.93	\$ 63	5.0	
Outstanding at September 30, 2011 and not yet vested	1,036	\$ 4.54	\$ 320	9.3	181	\$ 4.79	\$ 31	9.3	
Exercisable at September 30, 2011	851	\$ 6.00	\$ 76	5.5	687	\$ 10.03	\$ 32	3.9	

The Company issues new shares when stock options are exercised.

Restricted Stock

The Company measures restricted stock compensation costs based on the share price at the grant date less an estimate for forfeitures. The annual forfeiture rate used to calculate compensation expense was 7.5% for three months ended September 30, 2012 and 2011.

A summary of nonvested restricted stock awards as of September 30, 2012 and 2011 and changes during the three months then ended, is presented below:

(In thousands)	Awards	Weighted Average Grant - date Fair Value
Nonvested at July 1, 2012	74	\$ 515
Granted	38	190
Vested	(38)	(190)
Forfeited	(1)	(12)
Nonvested at September 30, 2012	73	\$ 503
Nonvested at July 1, 2011	155	\$ 1,076
Granted	30	107
Vested	(37)	(153)
Forfeited		
Nonvested at September 30, 2011	148	\$ 1,030

The Company issues share-based compensation awards with a vesting period ranging up to 3 years and a maximum contractual term of 10 years. As of September 30, 2012, there was approximately \$981 of total unrecognized compensation cost related to non-vested share-based

compensation awards granted under the Plans. That cost is expected to be recognized over a weighted average period of 1.7 years.

Employee Stock Purchase Plan

In February 2003, the Company's shareholders approved an Employee Stock Purchase Plan (ESPP). Employees eligible to participate in the ESPP may purchase shares of the Company's stock at 85% of the lower of the fair market value of the common stock on the first day of the calendar quarter, or the last day of the calendar quarter. Under the ESPP, employees can authorize the Company to withhold up to 10% of their compensation during any quarterly offering period, subject to certain limitations. The ESPP was implemented on April 1, 2003 and is qualified under Section 423 of the Internal Revenue Code. The Board of Directors authorized an aggregate total of 1,125 shares of the Company's common stock for issuance under the ESPP. During the three months ended September 30, 2012 and 2011, 32 shares and 13 shares were issued under the ESPP, respectively. As of September 30, 2012, 371 total cumulative shares have been issued under the ESPP.

Note 18. Employee Benefit Plan

The Company has a defined contribution 401k plan (the Plan) covering substantially all employees. Pursuant to the Plan provisions, the Company is required to make matching contributions equal to 50% of each employee's contribution, but not to exceed 4% of the employee's compensation for the Plan year. Contributions to the Plan during the three months ended September 30, 2012 and 2011 were \$164 and \$84, respectively.

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Note 19. Income Taxes

The Company uses the liability method to account for income taxes. Deferred tax assets and liabilities are determined based on the difference between the financial statement and tax bases of assets and liabilities as measured by the enacted tax rates which will be in effect when these differences reverse. Deferred tax expense/(benefit) is the result of changes in deferred tax assets and liabilities.

The provision for federal, state and local income taxes for the three months ended September 30, 2012 and 2011 was tax expense of \$2,277 and \$212, respectively, with effective tax rates of 44% and 49%, respectively. The effective tax rate for the three months ended September 30, 2012 was lower compared to the three months ended September 30, 2011 due primarily to foreign losses relative to expected pre-tax income for Fiscal 2013. This decrease was partially offset by the effects of a Pennsylvania tax law change which lowered the Company's apportionment factor within the state. The impact of this change caused the Company to reduce its deferred tax assets by approximately \$217, and therefore increased the effective tax rate by 4% for the three months ended September 30, 2012. Additionally, nondeductible incentive stock option compensation expenses relative to the expected pre-tax income for Fiscal 2013 resulted in a slight decrease in the effective rate compared to Fiscal 2012. The Company expects its overall effective tax rate will be approximately 39% to 41% for the full year ended June 30, 2013.

The Company may recognize the tax benefit from an uncertain tax position claimed on a tax return only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position should be measured based on the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement.

As of September 30, 2012 and June 30, 2012, the Company reported total unrecognized tax benefits of \$280. As a result of the positions taken during the period, the Company has not recorded any interest and penalties for the period ended September 30, 2012 in the statement of operations and no cumulative interest and penalties have been recorded either in the Company's statement of financial position as of September 30, 2012 and June 30, 2012. The Company will recognize interest accrued on unrecognized tax benefits in interest expense and any related penalties in operating expenses. The Company does not believe that the total unrecognized tax benefits will significantly increase or decrease in the next twelve months.

The Company files income tax returns in the United States federal jurisdiction, Pennsylvania, New Jersey and California. The Company's tax returns for Fiscal 2009 and prior generally are no longer subject to review as such years generally are closed. The Company believes that an unfavorable resolution for open tax years would not be material to the financial position of the Company.

Note 20. Related Party Transactions

The Company had sales of approximately \$322 and \$181 during the three months ended September 30, 2012 and 2011, respectively, to a generic distributor, Auburn Pharmaceutical Company (Auburn). Jeffrey Farber (the related party), Chairman of the Board and the son of William Farber, Chairman Emeritus of the Board of Directors and principal shareholder of the Company, is the owner of Auburn. Accounts receivable includes amounts due from the related party of approximately \$325 and \$234 at September 30, 2012 and June 30, 2012, respectively. In the Company's opinion, the terms of these transactions were not more favorable to the related party than would have been to a non-related party.

In January 2005, Lannett Holdings, Inc. entered into an agreement in which the Company purchased for \$100 and future royalty payments the proprietary rights to manufacture and distribute a product for which Pharmeral, Inc. (Pharmeral) owned the ANDA. In Fiscal 2008, the Company obtained FDA approval to use the proprietary rights. Arthur P. Bedrosian, President and Chief Executive Officer of the Company, Inc. currently owns 100% of Pharmeral. This transaction was approved by the Board of Directors of the Company and in their opinion the terms were not more favorable to the related party than they would have been to a non-related party. In May 2008, Mr. Bedrosian and Pharmeral waived their rights to any royalty payments on the sales of the drug by Lannett under Lannett's current ownership structure. Should Lannett undergo a change in control where a third party is involved, this royalty would be reinstated. The registered trademark OB-Natal® was transferred to Lannett for one dollar from Mr. Bedrosian.

Lannett Company, Inc. paid a management consultant, who is related to Mr. Bedrosian, \$29 in fees during the three months ended September 30, 2012 and \$25 in fees during the three months ended September 30, 2011. This consultant provided management, construction planning, laboratory set up and administrative services in regards to the Company's initial set up of its bio-study laboratory in a foreign country. It is expected that this consultant will continue to be utilized throughout fiscal year 2013. In the Company's opinion, the fee rates paid to this consultant and the expenses reimbursed to him were not more favorable than what would have been paid to a non-related party.

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Note 21. Material Contracts with Suppliers

Jerome Stevens Pharmaceuticals agreement:

The Company's primary finished product inventory supplier is Jerome Stevens Pharmaceuticals, Inc. (JSP), in Bohemia, New York. Purchases of finished goods inventory from JSP accounted for approximately 59% of the Company's inventory purchases during the three months ended September 30, 2012 and 2011. On March 23, 2004, the Company entered into an agreement with JSP for the exclusive distribution rights in the United States to the current line of JSP products, in exchange for 4,000 shares of the Company's common stock. The JSP products covered under the agreement included Butalbital, Aspirin, Caffeine with Codeine Phosphate Capsules, Digoxin Tablets and Levothyroxine Sodium Tablets, sold generically and under the brand name Unithroid®. The term of the agreement is ten years, beginning on March 23, 2004 and continuing through March 22, 2014. Both Lannett and JSP have the right to terminate the contract if one of the parties does not cure a material breach of the contract within thirty (30) days of notice from the non-breaching party.

During the term of the agreement, the Company is required to use commercially reasonable efforts to purchase minimum dollar quantities of JSP's products being distributed by the Company. The minimum quantity to be purchased in the first year of the agreement is \$15,000. Thereafter, the minimum quantity to be purchased increases by \$1,000 per year up to \$24,000 for the last year of the ten-year contract. The Company has met the minimum purchase requirement for the first eight years of the contract, but there is no guarantee that the Company will be able to continue to do so in the future. If the Company does not meet the minimum purchase requirements, JSP's sole remedy is to terminate the agreement.

Under the agreement, JSP is entitled to nominate one person to serve on the Company's Board of Directors (the Board) provided, however, that the Board shall have the right to reasonably approve any such nominee in order to fulfill its fiduciary duty by ascertaining that such person is suitable for membership on the board of a publicly traded corporation. Suitability is determined by, but not limited to, the requirements of the Securities and Exchange Commission, the NYSE MKT, and other applicable laws, including the Sarbanes-Oxley Act of 2002. As of September 30, 2012, JSP has not exercised the nomination provision of the agreement.

The Company's financial condition, as well as its liquidity resources, is very dependent on an uninterrupted supply of product from JSP. Should there be an interruption in the supply of product from JSP for any reason, this event would have a material impact to the financial condition of Lannett.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

The following information should be read in conjunction with the consolidated financial statements and notes in Part I, Item 1 of this Quarterly Report and with Management's Discussion and Analysis of Financial Condition and Results of Operations contained in the Company's Annual Report on Form 10-K for the fiscal year ended June 30, 2012.

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This Report on Form 10-Q and certain information incorporated herein by reference contain forward-looking statements which are not historical facts made pursuant to the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements are not promises or guarantees and investors are cautioned that all forward-looking statements involve risks and uncertainties, including but not limited to the impact of competitive products and pricing, product demand and market acceptance, new product development, the regulatory environment, including without limitation, reliance on key strategic alliances, availability of raw materials, fluctuations in operating results and other risks detailed from time to time in the Company's filings with the Securities and Exchange Commission. These statements are based on management's current expectations and are naturally subject to uncertainty and changes in circumstances. We caution you not to place undue reliance upon any such forward-looking statements which speak only as of the date made. Lannett is under no obligation to, and expressly disclaims any such obligation to, update or alter its forward-looking statements, whether as a result of new information, future events or otherwise.

Critical Accounting Policies

The discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amount of assets and liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities at the date of our financial statements. Actual results may differ from these estimates under different assumptions or conditions.

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Critical accounting policies are defined as those that are reflective of significant judgments and uncertainties and potentially result in materially different results under different assumptions and conditions. We believe that our critical accounting policies include those described below:

Revenue Recognition - The Company recognizes revenue when its products are shipped. At this point, title and risk of loss have transferred to the customer and provisions for estimates, including rebates, promotional adjustments, price adjustments, returns, chargebacks, and other potential adjustments are reasonably determinable. Accruals for these provisions are presented in the consolidated financial statements as rebates, chargebacks and returns payable and reductions to net sales. The change in the reserves for various sales adjustments may not be proportionally equal to the change in sales because of changes in both the product and the customer mix. Increased sales to wholesalers will generally require additional accruals as they are the primary recipient of chargebacks and rebates. Incentives offered to secure sales vary from product to product. Provisions for estimated rebates and promotional credits are estimated based upon contractual terms. Provisions for other customer credits, such as price adjustments, returns, and chargebacks, require management to make subjective judgments on customer mix. Unlike branded innovator drug companies, Lannett does not use information about product levels in distribution channels from third-party sources, such as IMS and Wolters Kluwer, in estimating future returns and other credits. Lannett calculates a chargeback/rebate rate based on contractual terms with its customers and applies this rate to customer sales. The only variable is customer mix, and this assumption is based on historical data and sales expectations.

Chargebacks The provision for chargebacks is the most significant and complex estimate used in the recognition of revenue. The Company sells its products directly to wholesale distributors, generic distributors, retail pharmacy chains, and mail-order pharmacies. The Company also sells its products indirectly to independent pharmacies, managed care organizations, hospitals, nursing homes, and group purchasing organizations, collectively referred to as indirect customers. Lannett enters into agreements with its indirect customers to establish pricing for certain products. The indirect customers then independently select a wholesaler from which to actually purchase the products at these agreed-upon prices. Lannett will provide credit to the wholesaler for the difference between the agreed-upon price with the indirect customer and the wholesaler's invoice price if the price sold to the indirect customer is lower than the direct price to the wholesaler. This credit is called a chargeback. The provision for chargebacks is based on expected sell-through levels by the Company's wholesale customers to the indirect customers and estimated wholesaler inventory levels. As sales to the large wholesale customers, such as Cardinal Health, AmerisourceBergen, and McKesson increase, the reserve for chargebacks will also generally increase. However, the size of the increase depends on the product mix and the amount of those sales that end up at indirect customers with which the Company has specific chargeback agreements. The Company continually monitors the reserve for chargebacks and makes adjustments when management believes that expected chargebacks on actual sales may differ from actual chargeback reserves.

Rebates Rebates are offered to the Company's key chain drug store, distributor and wholesaler customers to promote customer loyalty and increase product sales. These rebate programs provide customers with rebate credits upon attainment of pre-established volumes or attainment of net sales milestones for a specified period. Other promotional programs are incentive programs offered to the customers. As a result of the Patient Protection and Affordable Care Act (PPACA) enacted in the U.S. in March 2010, the Company participates in a new cost sharing program for certain Medicare Part D beneficiaries designed primarily for the sale of brand drugs and certain generic drugs if their FDA approval was granted under a New Drug Application (NDA) or 505(b) NDA versus an Abbreviated New Drug Application (ANDA). Because our drugs used for the treatment of thyroid deficiency and our Morphine Sulfate Oral Solution product were approved by the FDA as a 505(b)(2) NDA, they are considered branded drugs for purposes of the PPACA. Drugs purchased under this program during Medicare Part D coverage gap (commonly referred to as the donut hole) result in additional rebates. At the time of shipment, the Company estimates reserves for rebates and other promotional credit programs based on the specific terms in each agreement. The reserve for rebates increases as sales to certain wholesale and retail customers increase. However, since these rebate programs are not identical for all customers, the size of the reserve will depend on the mix of customers that are eligible to receive rebates.

Returns Consistent with industry practice, the Company has a product returns policy that allows customers to return product within a specified period prior to and subsequent to the product's lot expiration date in exchange for a credit to be applied to future purchases. The Company's policy requires that the customer obtain pre-approval from the Company for any qualifying return. The Company estimates its provision for

returns based on historical experience, changes to business practices, and credit terms. While such experience has allowed for reasonable estimations in the past, history may not always be an accurate indicator of future returns. The Company continually monitors the provisions for returns and makes adjustments when management believes that actual product returns may differ from established reserves. Generally, the reserve for returns increases as net sales increase. The reserve for returns is included in the rebates, chargebacks and returns payable account on the balance sheet.

Other Adjustments Other adjustments consist primarily of price adjustments, also known as shelf stock adjustments, which are credits issued to reflect decreases in the selling prices of the Company's products that customers have remaining in their inventories at the time of the price reduction. Decreases in selling prices are discretionary decisions made by management to reflect competitive market conditions. Amounts recorded for estimated shelf stock adjustments are based upon specified terms with direct customers,

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estimated declines in market prices, and estimates of inventory held by customers. The Company regularly monitors these and other factors and evaluates the reserve as additional information becomes available. Other adjustments are included in the rebates, chargebacks and returns payable account on the balance sheet.

The following tables identify the reserves for each major category of revenue allowance and a summary of the activity for three months ended September 30, 2012 and 2011. Unless we have specific information to indicate otherwise, actual credits issued in a given year are assumed to be related to sales recorded in prior years based on the Company's returns policy.

For the Three Months Ended September 30, 2012

(In thousands) Reserve Category	Chargebacks	Rebates	Returns	Other	Total
Reserve Balance as of July 1, 2012	\$ 7,063	\$ 4,436	\$ 5,540	\$	\$ 17,039
Actual credits issued related to sales recorded in prior fiscal years	(6,504)	(3,743)	(875)	(55)	(11,177)
Reserves or (reversals) charged during Fiscal 2013 related to sales in prior fiscal years	(372)	105		55	(212)
Reserves charged to net sales during Fiscal 2013 related to sales recorded in Fiscal 2013	19,350	5,675	1,405	139	26,569
Actual credits issued related to sales recorded in Fiscal 2013	(11,490)	(2,277)		(139)	(13,906)
Reserve Balance as of September 30, 2012	\$ 8,047	\$ 4,196	\$ 6,070	\$	\$ 18,313

For the Three Months Ended September 30, 2011

(In thousands) Reserve Category	Chargebacks	Rebates	Returns	Other	Total
Reserve Balance as of July 1, 2011	\$ 5,497	\$ 2,925	\$ 5,142	\$	\$ 13,564
Actual credits issued related to sales recorded in prior fiscal years	(5,262)	(2,686)	(1,412)	(92)	(9,452)
Reserves or (reversals) charged during Fiscal 2012 related to sales in prior fiscal years	(36)	72		92	128
Reserves charged to net sales during Fiscal 2012 related to sales recorded in Fiscal 2012	17,477	4,358	1,337	202	23,374
Actual credits issued related to sales recorded in Fiscal 2012	(11,119)	(1,943)		(202)	(13,264)

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Reserve Balance as of September 30, 2011	\$	6,557	\$	2,726	\$	5,067	\$	14,350
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The following tables compare the reserve balances at September 30, 2012 and June 30, 2012:

(In thousands)	September 30,			June 30,		
	2012		%	2012		%
Chargeback reserve	\$	8,047	44%	\$	7,063	41%
Rebate reserve		4,196	23%		4,436	26%
Return reserve		6,070	33%		5,540	33%
Other reserve			%			%
	\$	18,313	100%	\$	17,039	100%

The total reserve for chargebacks, rebates, returns and other adjustments increased from \$17,039,000 at June 30, 2012 to \$18,313,000 September 30, 2012. The increase in chargeback reserves is due primarily to an increase in inventory levels at wholesale distribution centers as a result of increased gross sales during Fiscal 2013 as compared to Fiscal 2012. The activity in the Other category for the quarter ended September 30, 2012 includes shelf-stock, shipping and other sales adjustments.

Inventories - The Company values its inventory at the lower of cost (determined by the first-in, first-out method) or market, regularly reviews inventory quantities on hand, and records a provision for excess and obsolete inventory based primarily on estimated forecasts of product demand and production requirements. The Company's estimates of future product demand may prove to be inaccurate, in which case it may have understated or overstated the provision required for excess and obsolete inventory.

Income Taxes - The Company accounts for income taxes in accordance with FASB ASC 740. Deferred tax assets and liabilities are determined based on the difference between the financial statement and tax bases of assets and liabilities as measured by presently enacted tax rates which will be in effect when these differences reverse. Deferred tax expense/(benefit) is the result of changes in deferred tax assets and liabilities. The Company may recognize the tax benefit from an uncertain tax position claimed on a tax return only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position should be measured based on the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement. The authoritative standards issued by the FASB also provide guidance on de-recognition, classification, interest and penalties on income taxes, accounting in interim periods and requires increased disclosures. The factors used to assess the likelihood of realization of its net deferred tax assets are the Company's forecast of future taxable income and available tax planning strategies that could be implemented to realize the net deferred tax assets. Failure to achieve forecasted taxable income in applicable tax jurisdictions could affect the ultimate realization of deferred tax assets and could result in an increase in the Company's effective tax rate on future earnings.

Intangible Assets - Indefinite-lived intangible assets are tested for impairment annually or more frequently if events or changes in circumstances indicate that the asset might be impaired. Definite-lived intangible assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of the asset may not be recoverable.

Indefinite-lived intangible assets are considered impaired if the carrying value of the asset is greater than fair value. The fair value is determined by using a discounted cash flow analysis. Definite-lived intangible assets are considered impaired if the carrying value of the asset is greater than the undiscounted cash flows related to the assets. Our cash flow models are highly reliant on various assumptions which are considered

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level 3 inputs, including estimates of future cash flow (including long-term growth rates), discount rates, and expectations about variations in the amount and timing of cash flows and the probability of achieving the estimated cash flows. As of September 30, 2012 and June 30, 2012, the Company had one indefinite-lived intangible asset in the amount of \$149,000. The Company performed the annual impairment test in the fourth quarter of Fiscal 2012 and determined that no impairment charges were required. No events or changes in circumstances were identified during the three months ended September 30, 2012 or the fiscal year ended June 30, 2012 that would indicate a need to perform impairment analyses for definite-lived intangible assets. As such, no impairment charges were required.

Definite-lived intangible assets are amortized over the estimated useful lives, generally for periods ranging from 10 to 15 years. The Company continually evaluates the reasonableness of the useful lives of these assets. For the three months ended September 30, 2012, and 2011, the Company incurred amortization expense of \$471,000 and \$468,000, respectively.

Share-based Compensation - Share-based compensation costs are recognized over the vesting period based on the fair value of the instrument on the date of grant less an estimate for forfeitures. The Company uses the Black-Scholes option-pricing model to determine the fair value of stock options and the share price on the grant date to value restricted stock. The fair value model includes various assumptions, including the expected volatility, expected life of the awards, and risk-free interest rates. These assumptions involve inherent uncertainties based on market conditions which are generally outside the Company's control. Changes in these assumptions could have a material impact on share-based compensation costs recognized in the financial statements. Refer to Note 17

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of our Consolidated Financial Statements for a detailed description of our Black-Scholes weighted average assumptions for the three months ended September 30, 2012 and 2011.

Results of Operations - Three months ended September 30, 2012 compared with three months ended September 30, 2011

Net sales for the three months ended September 30, 2012 (Fiscal 2013) increased 22% to \$35,294,000 from \$28,878,000 for the three months ended September 30, 2011 (Fiscal 2012). The following factors contributed to the \$6,416,000 increase in sales:

Medical Indication	Sales volume change %	Sales price change %
Antibiotic	10%	(9)%
Cardiovascular	158%	24%
Gallstone Prevention	18%	4%
Glaucoma	(4)%	37%
Migraine Headache	(25)%	3%
Obesity	138%	2%
Pain Management	(20)%	24%
Thyroid Deficiency	1%	4%

Sales of drugs for cardiovascular treatment increased by \$4,590,000, due to increased sales of a recently approved product for the treatment of hypertension which commenced shipping at the end of December 2011. Products used in the management of Obesity increased by \$763,000, which was largely due to increased volumes related to products launched in October 2011 and April 2012. Sales of drugs for the treatment of Thyroid Deficiency increased by \$603,000, primarily as a result of price increases on key products within the medical indication.

The Company sells its products to customers in various categories. The table below presents the Company's net sales to each category for the three months ended September 30:

(In thousands) Customer Category	2012	2011
Wholesaler/Distributor	\$ 19,028	\$ 16,150
Retail Chain	12,398	11,675
Mail-Order Pharmacy	3,868	1,053
Total	\$ 35,294	\$ 28,878

The sales to wholesaler/distributor increased primarily as a result of increased net sales in a variety of products including the Obesity and Thyroid medical indications as discussed above. Mail-order pharmacy sales increased primarily as a result of increased sales due to a recently approved product for the treatment of hypertension which commenced shipping in December 2011.

Cost of sales, including amortization and product royalty expense, for the first quarter increased 7% to \$21,668,000 in Fiscal 2013 from \$20,262,000 in Fiscal 2012. The increase primarily reflected the impact of the 22% increase in sales, partially offset by changes in the mix of products sold, as well as increased manufacturing efficiencies.

Amortization expense included in the cost of sales change above primarily relates to the JSP Distribution Agreement. For the remaining term of the JSP Distribution Agreement, the Company will incur annual amortization expense of approximately \$1,785,000.

Gross profit margins for the first quarter of Fiscal 2013 and Fiscal 2012 were 39% and 30%, respectively. Gross profit percentage increased primarily due a change in the mix of products sold as discussed above, in addition to manufacturing efficiencies. While the Company is continuously striving to keep product costs low, there can be no guarantee that profit margins will stay consistent in future periods. Pricing pressure from competitors and costs of producing or purchasing new drugs may also fluctuate in future periods. Changes in the future sales product mix may also occur.

Research and development (R&D) expenses in the first quarter increased 55% to \$3,764,000 for Fiscal 2013 from \$2,426,000 for Fiscal 2012. The increase is primarily due to increased costs related to biostudies as a result of the timing of milestone achievements

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and third party laboratory service costs for products in development. The Company expenses all production costs as R&D until the drug is approved by the FDA. R&D expenses may fluctuate from period to period, based on R&D plans for submission to the FDA.

Selling, general and administrative (SG&A) expenses in the first quarter increased 30% to \$6,171,000 in Fiscal 2013 from \$4,745,000 in Fiscal 2012. The increase is primarily due to additional compensation related costs incurred in Fiscal 2013 but not in Fiscal 2012, expenses incurred in Fiscal 2013 related to fees under the Generic Drug User Fee Act which were not incurred in Fiscal 2012, and an increase in legal costs incurred in Fiscal 2013 over those incurred in Fiscal 2012. While the Company is focused on controlling costs, increases in personnel costs may have an ongoing and longer lasting impact on the administrative cost structure. Other costs are being incurred to facilitate improvements in the Company's infrastructure. These costs are expected to be temporary investments in the future of the Company and may not continue at the same level.

During the first quarter of Fiscal 2013, the Company entered into a favorable settlement agreement related to litigation the Company had been involved in since January 2010. As a result of the agreement the Company recorded a gain in the amount of \$1,250,000. As of September 30, 2012, the Company had recorded all amounts related to the agreement.

Interest expense in the first quarter of Fiscal 2013 decreased to \$63,000 compared to \$77,000 in Fiscal 2012 due to lower levels of long-term debt. Interest and dividend income totaling \$35,000 in Fiscal 2013 decreased compared to \$53,000 in Fiscal 2012. The Company recorded gains on trading investment securities during the first quarter of Fiscal 2013 totaling \$234,000, of which \$270,000 were unrealized gains and \$36,000 were realized losses. The Company recorded losses on trading investment securities during the first quarter of Fiscal 2012 totaling \$999,000, of which \$826,000 were unrealized losses and \$173,000 were realized losses.

The Company recorded income tax expense in the first quarter of Fiscal 2013 of \$2,277,000 compared to income tax expense of \$212,000 in the first quarter of Fiscal 2012. The effective tax rate for the three months ended September 30, 2012 was 44%, compared to 49% for the three months ended September 30, 2011. The effective tax rate for the three months ended September 30, 2012 was lower compared to the three months ended September 30, 2011 due primarily to foreign losses relative to expected pre-tax income for Fiscal 2013. This decrease was partially offset by the effects of a Pennsylvania tax law change which lowered the Company's apportionment factor within the state. The impact of this change caused the Company to reduce its deferred tax assets by approximately \$217,000, and therefore increased the effective tax rate by 4% for the three months ended September 30, 2012. Additionally, nondeductible incentive stock option compensation expenses relative to the expected pre-tax income for Fiscal 2013 resulted in a slight decrease in the effective rate compared to Fiscal 2012. The Company expects its overall effective tax rate will be approximately 39% to 41% for the full year ended June 30, 2013.

The Company reported a net income attributable to Lannett of approximately \$2,926,000 in the first quarter of Fiscal 2013, or \$0.10 basic and diluted earnings per share, as compared to net income attributable to Lannett of approximately \$206,000 in the first quarter Fiscal 2012, or \$0.01 basic and diluted earnings per share.

Liquidity and Capital Resources

The Company has historically financed its operations with cash flow generated from operations, supplemented with borrowings from various government agencies and financial institutions. At September 30, 2012, working capital was \$70,511,000 as compared to \$66,089,000 at June

30, 2012, an increase of \$4,422,000.

Net cash provided by operating activities of \$2,780,000 in the first three months of Fiscal 2013 reflected net income of \$2,943,000, after adjusting for non-cash items of \$1,239,000, which included a gain on litigation settlement of \$1,250,000 and proceeds from litigation settlement of \$450,000, as well as cash used by changes in operating assets and liabilities of \$1,402,000. Significant changes in operating assets and liabilities are comprised of:

- A decrease in trade accounts receivable of \$155,000 resulting from the timing of receipts related to sales in the fourth quarter of Fiscal 2012. The Company's days sales outstanding (DSO), based on gross sales, for Fiscal 2013 was 61 days. The level of DSO at September 30, 2012 is comparable to the Company's expectation that DSO will be in the 60 to 70 day range based on 60 day payment terms for most customers.
- An increase in inventories of \$542,000 primarily due to the timing of fulfillment of customer orders and inventory on hand related to new product approvals.
- A decrease in income taxes receivable of \$2,120,000 as a result of a federal tax refund received in the amount of \$2,208,000.
- An increase in income taxes payable of \$1,679,000 resulting from Fiscal 2013 estimated taxable income.
- A decrease in accounts payable of \$5,349,000 due to the timing of payments at the end of the quarter.
- An increase in rebates, chargebacks and returns payable of \$1,274,000 due primarily to an increase in inventory levels at wholesale distribution centers as a result of increased gross sales during Fiscal 2013 as compared to Fiscal 2012.

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- A decrease in accrued payroll and payroll related costs of \$860,000 primarily related to Fiscal 2013 payments of incentive compensation accrued during Fiscal 2012, partially offset by incentive compensation costs accrued during Fiscal 2013.

Net cash provided by investing activities of \$1,141,000 for the three months ended September 30, 2012 is mainly the result of proceeds of \$4,808,000 from the sale of investment securities partially offset by purchases of investment securities of \$2,916,000 and purchases of property, plant and equipment of \$821,000.

Net cash used in financing activities of \$163,000 for the three months ended September 30, 2012 was primarily due to the purchase of shares of treasury stock, pursuant to the Company's share repurchase program, totaling \$334,000, partially offset by proceeds from the issuance of stock related to employee stock plans of \$296,000. Additional financing activities included scheduled debt repayments of \$125,000.

Long-term debt amounts due, for the twelve month periods ending September 30 are as follows:

(In thousands)	Amounts Payable to Institutions
2013	\$ 651
2014	673
2015	535
2016	548
2017	562
Thereafter	4,067
	\$ 7,036

The Company has a \$3,000,000 line of credit from Wells Fargo Bank, N.A. (Wells Fargo) that was scheduled to expire on March 31, 2012. The line of credit was renewed and extended until April 30, 2013 and bears interest of 1-month LIBOR Market Index Rate plus 2.00%. The interest rate at September 30, 2012 and June 30, 2012 was 2.21% and 2.22%. Availability under the line of credit is reduced by outstanding letters of credit. As of September 30, 2012 and June 30, 2012, the Company had \$3,000,000 and \$2,995,000 of availability under the line of credit, respectively. The availability fee on the unused balance of the line of credit is 0.375%. The line of credit is collateralized by the working capital assets of the Company. As of September 30, 2012, the Company was in compliance with the financial covenants under the agreement.

The Company borrowed \$1,250,000 through the Pennsylvania Industrial Development Authority (PIDA). The Company is required to make equal payments each month for 180 months starting February 1, 2006 with interest of 2.75% per annum. The PIDA Loan has \$757,000 outstanding as of September 30, 2012 with \$82,000 currently due.

In April 1999, the Company entered into a loan agreement with the Philadelphia Authority for Industrial Development (the Authority or PAID), to finance future construction and growth projects of the Company. The Authority issued \$3,700,000 in tax-exempt variable rate demand and fixed rate revenue bonds to provide the funds to finance such growth projects pursuant to a trust indenture (the Trust Indenture). A portion of the Company's proceeds from the bonds was used to pay for bond issuance costs of \$170,000. The Trust Indenture requires that the Company repay the Authority loan through installment payments beginning in May 2003 and continuing through May 2014, the year the bonds mature.

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The bonds bear interest at the floating variable rate determined by the organization responsible for selling the bonds. The interest rate fluctuates on a weekly basis. The effective interest rate at September 30, 2012 and June 30, 2012 was 0.39% and 0.38%, respectively. At September 30, 2012, the Company has \$290,000 outstanding on the Authority loan, of which \$140,000 is classified as currently due. In April 1999, an irrevocable letter of credit of \$3,770,000 was issued by Wells Fargo. This letter of credit is renewed annually to secure payment of the outstanding Authority loan balance and a portion of the related accrued interest. At September 30, 2012, no portion of the letter of credit has been utilized.

The Company has negotiated a set of mortgages on its Townsend Road facility with both Wells Fargo and PIDA. The Wells Fargo portion of the loan is for \$3,056,000, bears a floating interest rate of the 1-Month LIBOR rate plus 2.95%, amortizes the loan over a 15 year term and has an 8 year maturity date. The effective interest rate at September 30, 2012 and June 30, 2012 was 3.16% and 3.20%, respectively. The PIDA portion of the loan is for \$2,000,000, bears an interest rate of 3.75% and matures in 15 years. Both loans closed and were funded in May 2011. At September 30, 2012, the Company has \$2,767,000 outstanding on the Wells Fargo portion of the loan, of which \$204,000 is classified as currently due. The PIDA Loan has \$1,873,000 outstanding as of September 30, 2012 with \$106,000 currently due.

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The Company has executed Security Agreements with Wells Fargo, PIDA and PIDC in which the Company has agreed to pledge its working capital, some equipment and its Townsend Road property to collateralize the amounts due.

The Company consolidates Cody LCI Realty, LLC, a variable interest entity (VIE), for which Cody Labs is the primary beneficiary. See Note 12 to our Consolidated Financial Statements for Consolidation of Variable Interest Entities. A mortgage loan with First National Bank of Cody related to the purchase of land and building by the VIE has also been consolidated in the Company's consolidated balance sheets. The mortgage requires monthly principal and interest payments of \$15,000. Effective February 2011, the interest rate was modified from a fixed rate of 7.5% to a floating rate with a floor of 4.5% and a ceiling of 9.0%, with payments to be made through April 2022. As of September 30, 2012, \$1,349,000 is outstanding under the mortgage loan, of which \$119,000 is classified as currently due with a rate of 4.5%. The mortgage is collateralized by the land and building.

Prospects for the Future

Generic pharmaceutical manufacturers and distributors are constantly faced with pricing pressures in the marketplace as competitors attempt to lure business from distributors, wholesalers and chain retailers by offering lower prices than the incumbent supplier. Lannett tries to differentiate itself in the marketplace by complementing its lower cost offerings with higher levels of customer service and quality of the products. But as Lannett enters Fiscal Year 2013, there is an increasing number of competitors on our key products that are attempting to supplant Lannett as the preferred vendor.

Beginning in the first quarter of Fiscal 2011, Lannett faced significant pricing challenges on its top two selling products. In order to keep the volume of business with the specific customers involved, Lannett chose to reduce its selling price on both of the products. These price reductions had and may continue to have a significant impact to the gross profit margins and profitability of Lannett expected in the future.

The Company has had difficulty marketing its Oxycodone HCl Solution product starting in the third quarter of Fiscal 2011 due to the current limitations by the DEA to grant additional manufacturing quota to Cody Labs for its production. This product contributed approximately \$3,800,000 in revenue in Fiscal 2012 and \$4,600,000 in Fiscal 2011. The loss of this product would have a significant impact to the gross profit margins and profitability of Lannett expected in the future.

The Company has several generic products under development. These products are all orally-administered, topical, injectable and parenteral products designed to be generic equivalents to brand named innovator drugs. The Company's developmental drug products are intended to treat a diverse range of indications. As one of the oldest generic drug manufacturers in the country, formed in 1942, Lannett currently owns several ANDAs for products which it does not manufacture and market. These ANDAs are dormant on the Company's records. Occasionally, the Company reviews such ANDAs to determine if the market potential for any of these older drugs has recently changed, so as to make it attractive for Lannett to reconsider manufacturing and selling it. If the Company makes the determination to introduce one of these products into the consumer marketplace, it must review the ANDA and related documentation to ensure that the approved product specifications, formulation and other factors meet current FDA requirements for the marketing of that drug. The Company would then redevelop the product and submit it to the FDA for supplemental approval. The FDA's approval process for ANDA supplements is similar to that of a new ANDA. Generally, in these situations, the Company must file a supplement to the FDA for the applicable ANDA, informing the FDA of any significant changes in the manufacturing process, the formulation, or the raw material supplier of the previously-approved ANDA. Recently, the FDA has announced that it will prioritize its review of 3,800 Chemistry Manufacturing and Control (CMC) supplements in order to make progress on reviewing a backlog of over 2,200 ANDAs. This could negatively impact the sales of future products.

The products under development are at various stages in the development cycle formulation, scale-up, and/or clinical testing. Depending on the complexity of the active ingredient's chemical characteristics, the cost of the raw material, the FDA-mandated requirement of bioequivalence studies, the cost of such studies and other developmental factors, the cost to develop a new generic product varies and on average can range from \$100,000 to \$1,700,000. Some of Lannett's developmental products will require bioequivalence studies, while others will not depending on the FDA's Orange Book classification. Since the Company has no control over the FDA review process, management is unable to anticipate whether or when it will be able to begin producing and shipping additional products.

The Company views its April 2007 acquisition of Cody Laboratories, Inc. (Cody Labs or Cody) as an important step in becoming a vertically integrated narcotics manufacturer and distributor by allowing it to concentrate on developing and completing its dosage form manufacturing in order to reduce narcotic API costs. In July 2008, the DEA granted Cody Labs a license to directly import raw poppy straw for conversion into API and/or various pharmaceutical products. Only six other companies in the U.S. have been granted this license to date. This license allows the Company to avoid increased costs associated with buying narcotic API from other manufacturers. The Company anticipates that it can use this license to become a vertically integrated manufacturer of narcotic

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products, as well as a supplier of API to the pharmaceutical industry. The Company believes that the aging domestic population may result in a higher demand for pain management pharmaceutical products and that it will be well-positioned to take advantage of this increased demand.

Cody Labs' manufacturing expertise in narcotic APIs will allow Lannett to build a market with limited domestic competition. The Company anticipates that the demand for narcotics and controlled drugs will continue to grow as the Baby Boomer generation ages and that it is well-positioned to take advantage of these opportunities by concentrating additional resources in the narcotics and controlled drugs area. The sale of pain management products approximated 17% of net sales for the year Fiscal 2012 and 14% of net sales for the Fiscal 2011. Due to the FDA's actions against Morphine Sulfate Oral Solution and a slowdown in the demand for one other product that is manufactured at Cody, Lannett incurred a decrease in the percentage of sales related to pain management products during Fiscal 2011. Since the Company received the FDA approval for its 505(b)(2) New Drug Application for Morphine Sulfate Oral Solution in June 2011, net sales related to pain management products have increased.

In addition to the efforts of its internal product development group, Lannett has contracted with several outside firms for the formulation and development of several new generic drug products. These outsourced R&D products are at various stages in the development cycle formulation, analytical method development and testing and manufacturing scale-up. These products are orally-administered solid dosage products, topical, injectable or parenterals intended to treat a diverse range of medical indications. We intend to ultimately transfer the formulation technology and manufacturing process for most of these R&D products to our own commercial manufacturing sites. The Company initiated these outsourced R&D efforts to complement the progress of its own internal R&D efforts.

Occasionally, the Company will work on developing a drug product that does not require FDA approval. Certain prescription drugs do not require prior FDA approval before marketing. They include, for instance, drugs listed as DESI drugs (Drug Efficacy Study implementation) which are under evaluation by FDA, Grandfathered Drugs, and prescription multivitamin drugs. A generic manufacturer may sell products which are chemically equivalent to innovator drugs, under FDA rules by simply performing and internally documenting the normal research and development involved in bringing a new product to market. Under this scenario, a generic company can forego the time required for FDA approval.

More specifically, certain products, marketed prior to the Federal Food, Drug and Cosmetic Act may be considered GRASE or Grandfathered. GRASE products are those old drugs that do not require prior approval from FDA in order to be marketed because they are generally recognized as safe and effective based on published scientific literature. Similarly, Grandfathered products are those which entered the market before the passage of the 1938 act or the 1962 amendments to the act. Under the grandfather clause, such a product is exempted from the effectiveness requirements [of the act] if its composition and labeling have not changed since 1962 and if, on the day before the 1962 amendments became effective, it was (1) used or sold commercially in the United States, (2) not a new drug as defined by the act at that time, and (3) not covered by an effective application. Recently, the FDA has increased its efforts to force companies to file and seek FDA approval for these GRASE products. Efforts have included granting market exclusivity to approved GRASE products and issuing notices to companies currently producing these products.

The Company has entered supply and development agreements with certain international companies, including Wintac of India, Orion Pharma of Finland, Azad Pharma AG and Swiss Caps of Switzerland, Pharma 2B (formerly Pharmaseed) of Israel and the GC Group, as well as certain domestic companies, including JSP, Banner Pharmacaps, Cerovene and Summit Bioscience. The Company is currently in negotiations on similar agreements with other international companies, through which Lannett will market and distribute products manufactured by Lannett or by third parties. Lannett intends to use its strong customer relationships to build its market share for such products, and increase future revenues and income.

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The majority of the Company's R&D projects are being developed in-house under Lannett's direct supervision and with Company personnel. Hence, the Company does not believe that its outside contracts for product development and manufacturing supply are material in nature, nor is the Company substantially dependent on the services rendered by such outside firms.

Lannett may increase its focus on certain specialty markets in the generic pharmaceutical industry. Such a focus is intended to provide Lannett customers with increased product alternatives in categories with relatively few market participants. While there is no guarantee that Lannett has the market expertise or financial resources necessary to succeed in such a market specialty, management is confident that such future focus will be well received by Lannett customers and increase shareholder value in the long run.

The Company plans to enhance relationships with strategic business partners, including providers of product development research, raw materials, active pharmaceutical ingredients as well as finished goods. Management believes that mutually beneficial strategic relationships in such areas, including potential financing arrangements, partnerships, joint ventures or acquisitions, could allow for potential competitive advantages in the generic pharmaceutical market. The Company plans to continue to explore such areas for potential opportunities to enhance shareholder value.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Lannett Company, Inc. (the Company) has debt instruments with variable interest rates. The Company has a \$3,000,000 line of credit from Wells Fargo Bank, N.A. (Wells Fargo) that was scheduled to expire on March 31, 2012. The line of credit was renewed and extended until April 30, 2013 and bears interest of 1-month LIBOR Market Index Rate plus 2.00%. The interest rate at September 30, 2012 and June 30, 2012 was 2.21% and 2.22%. Availability under the line of credit is reduced by outstanding letters of credit. As of September 30, 2012 and June 30, 2012, the Company had \$3,000,000 and \$2,995,000 of availability under the line of credit, respectively. The availability fee on the unused balance of the line of credit is 0.375%. The line of credit is collateralized by the working capital assets of the Company. As of September 30, 2012, the Company was in compliance with the financial covenants under the agreement.

The Company has negotiated a set of mortgages on its Townsend Road facility with both Wells Fargo and PIDA. The Wells Fargo portion of the loan is for \$3,056,000, bears a floating interest rate of the 1-Month LIBOR rate plus 2.95%, amortizes the loan over a 15 year term and has an 8 year maturity date. The effective interest rate at September 30, 2012 and June 30, 2012 was 3.16% and 3.20%, respectively. At September 30, 2012, the Company has \$2,767,000 outstanding on the loan, of which \$204,000 is classified as currently due.

A mortgage loan with First National Bank of Cody related to the purchase of land and building by Cody LCI Realty, LLC, a variable interest entity, has also been consolidated in the Company's consolidated balance sheets. The mortgage requires monthly principal and interest payments of \$15,000. Effective February 2011, the interest rate was modified from a fixed rate of 7.5% to a floating rate with a floor of 4.5% and a ceiling of 9.0%, with payments to be made through April 2022. As of September 30, 2012, \$1,349,000 is outstanding under the mortgage loan with a rate of 4.5%. The mortgage is collateralized by the land and building.

The Company invests in equity securities, U.S. government agency securities and corporate bonds, which are exposed to market and interest rate fluctuations. The interest and dividends earned on these investments may vary based on fluctuations in interest rate and market conditions.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

As of the end of the period covered by this Form 10-Q, management performed, with the participation of our Chief Executive Officer and Chief Financial Officer, an evaluation of the effectiveness of our disclosure controls and procedures as defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934, as amended (the Exchange Act). Our disclosure controls and procedures are designed to provide reasonable assurance that information required to be disclosed in the reports we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, to allow timely decisions regarding required disclosures.

Based upon the evaluation, the Chief Executive Officer and Chief Financial Officer concluded that Lannett's disclosure controls and procedures were effective as of the end of the period covered by this report.

Change in Internal Control Over Financial Reporting

There has been no change in Lannett's internal control over financial reporting during the three months ended September 30, 2012 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

None.

Regulatory Proceedings

Lannett Company, Inc. is engaged in an industry which is subject to considerable government regulation relating to the development, manufacturing and marketing of pharmaceutical products. Accordingly, incidental to its business, the Company periodically responds to inquiries or engages in administrative and judicial proceedings involving regulatory authorities, particularly the FDA and the Drug Enforcement Agency.

ITEM 1A. RISK FACTORS

Lannett Company, Inc.'s Annual Report on Form 10-K for the fiscal year ended June 30, 2012 includes a detailed description of its risk factors.

ITEM 6. EXHIBITS

(a) A list of the exhibits required by Item 601 of Regulation S-K to be filed as a part of this Form 10-Q is shown on the Exhibit Index filed herewith.

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SIGNATURES

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

LANNETT COMPANY, INC.

Dated: November 9, 2012

By: /s/ Arthur P. Bedrosian
Arthur P. Bedrosian
President and Chief Executive Officer

Dated: November 9, 2012

By: /s/ Martin P. Galvan
Martin P. Galvan
Vice President of Finance, Chief Financial Officer and Treasurer

Dated: November 9, 2012

By: /s/ G. Michael Landis
G. Michael Landis
Director of Financial Reporting and Principal Accounting
Officer

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Exhibit Index

31.1	Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	Filed Herewith
31.2	Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	Filed Herewith
32	Certifications of Chief Executive Officer and Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	Filed Herewith
101.INS	XBRL Instance Document*	
101.SCH	XBRL Extension Schema Document*	
101.CAL	XBRL Calculation Linkbase Document*	
101.DEF	XBRL Definition Linkbase Document*	
101.LAB	XBRL Label Linkbase Document*	
101.PRE	XBRL Presentation Linkbase Document*	

* Pursuant to Rule 406T of Regulation S-T, these interactive data files are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933 and are deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934 and otherwise are not subject to liability under these Sections.