Edited Transcript

Post 3Q 2013 Interim Management Statement Meeting with Analysts hosted by Iain Mackay, Group Finance Director

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Corporate participants:
Iain Mackay, Group Finance Director
Russell Picot, Group Chief Accounting Officer
Jane Leach, Head of Group Regulatory Reporting
Nick Collier, Head of Group Investor Relations

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Nick Collier, Head of Group Investor Relations

Welcome everybody. Just some administrative points: clearly this is going to be recorded, published and put up onto the IR website. Therefore, as a matter of protocol, before you ask questions, could you wait for the microphone to come to you and mention your name and firm so that it can all be recorded?

We have here Iain, Russell and Jane, all familiar faces, who will help you answer some questions, together with Rob Irvin. They can ask questions from Hong Kong as well.

Iain Mackay, Group Finance Director

This set of numbers is a quieter set of numbers, so there are fewer notable items coming through, which hopefully makes it easier for everybody to get to grips with what the true performance of the business has been over the quarter, as well as then building on the previous two quarters to understand year to date. We are reasonably happy with the trading conditions that we experienced in the third quarter. October has held reasonably consistently. Certainly, perhaps, some of the activity that we have seen coming through Global Banking and Markets has been a little bit slower in October and November. That is a seasonality aspect that we have certainly experienced and others have experienced on more than a few occasions. Overall, the trading conditions and the outlook are best described as stable and there are some areas of relative optimism in that respect.

The businesses remain focused on the three broad areas that we have laid out from a strategic perspective. Clearly, a very significant effort has been underway across the Group, but momentum is building in this respect around a consistent application of global standards; continued ongoing effort around simplifying and streamlining the business – we have accomplished a lot but there is an awful lot more to be accomplished in this particular regard; then, last but by absolutely no means least, a continued focus on identifying those areas, both geographically within the businesses and across the businesses, where we can continue to grow the business from a profitability perspective to continue to support progressive dividends going forward. In the round, we are happy with the progress that was made on a year-to-date basis. The performance of the third quarter, I think, is a reflection of the efforts of the teams over the year and manifested through the three months to 30 September, and that effort is clearly ongoing.

One key theme that has come out of the questions from yourselves and others is the regulatory capital management framework, my favourite topic. Jane and Russell are going to talk at great length about that this morning. Interestingly, but perhaps not surprisingly, there is a slightly increased focus on what is going on from a litigation and investigative perspective, which continues to occupy more than a little time of those operating in the industry today.

So with that, I am happy to take questions. We will open it up to those in the room, if you could, as Nick mentioned, repeat your name and the firm that you are with.

Thomas Rayner, Exane BNP Paribas (UK)

Can I ask you, Iain, on your fully loaded RWA numbers? 1,230 was the number, which looked like it was down by around 1% on the half year stage. This is all in CRD IV fully loaded. Your underlying loan growth looks like it is positive and it sounds as if that might strengthen going forward, given the economic outlook. Could you give us a feel for what you think the growth in that fully loaded RWA number might be over the near year or couple of years?

Iain Mackay

What we have experienced in the quarter is somewhat of an improvement in quality. Although we had growth coming through in the size of the book, we also experienced some reductions coming through in terms of the quality of the book, as well as a reduction across some of the traded positions as Global Banking and Markets repositioned parts of the book. They have repositioned parts of the book driven principally by business reasons but also in terms of restructuring transactions with clients to achieve a more efficient capital structure. That is clearly done in collaboration with clients on a one-on-one basis, such that the transaction is efficient for both the client and capital utilisation for ourselves: for example, better use of collateral netting within those transactions. There is also just a reduction of a number of

positions in high risk-weighted categories. We also had a significant run-off through disposition within the North American book, which was a particularly heavily weighted set of risk-weighted assets.

Those factors offset, to a very significant degree, the growth that we had experienced. The growth that we experienced was principally through growth of the mortgage book within Hong Kong and the United Kingdom, the two home markets, and to a lesser extent within Commercial Banking, where the growth was fairly muted. What we are really seeing there is that volumes are holding up but the nature of the book that we have, particularly in Asia, is that it is a fairly short duration book. Although we see volume churn quite actively in terms of contributing to the actual growth of the book, it is not that significant. However, there is, nonetheless, net interest income and transactional fees coming from that churn of a relatively short-dated book coming through trade and receivables financing.

In terms of trying to lay out any particular growth outlook that we have for risk-weighted assets, if I would say anything, the focus of the business is clearly to grow the business, but to do so in a particularly capital efficient manner. I do not think that is necessarily contradictory in terms of what the businesses have been able to accomplish this year. So we do not have a target set within our planning cycle for growing risk-weighted assets. If anything, we have a very sharp focus on reducing risk-weighted assets, principally through churn of the book into a more efficient structure.

Thomas Rayner

Is it fair to interpret that, whatever you think the loan growth might be, you would like the RWAs to be burning at a slower pace than they have been?

Iain Mackay

On a total, all considered, yes, because we are going to continue to run off the North American book. We are going to continue to reposition within Global Banking and Markets to a more efficient standing. At the same time as we break this down, which is really what the flow tables are for – to try and give you a sense as to what is going on from a size-of-the-book perspective, a quality-of-the-book perspective and what is happening from a regulatory change standpoint – what we are doing, to be very blunt, is that there is, for much discussed reasons, uncertainty within the regulatory space at the moment. We have concerns that there is, from regulatory change, a likelihood to be upward pressure on risk-weighted assets. As a consequence of that, there is, to say the least, a not-insignificant focus on trying to mitigate as much of that upward pressure as we possibly can through the actions that I have described.

We are going to grow. We are not going to sit down here and talk about the rates of growth beyond general indications in GDP and the opportunity within those markets to grow share of wallet and market share. But there is a very, very sharp focus on managing risk-weighted assets.

Sandy Chen, Cenkos Securities PLC

To carry on from that, looking at the flow statement on RWAs on page 15, what is interesting is that the growth in flow, as you were saying, in book size in Europe, Hong Kong and the rest of Asia-Pac is driving a lot of the business. Would that be the same under fully loaded Basel III in terms of the RWA movement? What I am trying to get at is that Hong Kong and the rest of Asia Pac on a return-on-risk-weighted-asset basis is actually quite good. If the fully loaded Basel III RWA uplift is lower for those regions, given the product mix and all that kind of stuff, might the increase in mix-adjusted profitability on a return-on-risk-weighted-asset basis be better?

Russell Picot, Group Chief Accounting Officer

My take on this is that CRD IV does not fundamentally rewrite the risk-weighted asset rules for HSBC's core business. As Iain says, there are some technical areas that we are working through and waiting to come through. One or two of those do have the propensity to impact one or two aspects of our business, which we are going to have to work through. There is a lot of work being done on mitigation. But if you look at, for example, the engines of mortgage lending in Hong Kong and the UK, they do not change under CRD IV. The UK regulatory authorities, the FPC and the PRA, are doing a lot of work on capital buffers, the structure of regulatory capital and thinking about the way stress testing will relate to that. But

the actual dollar-for-dollar – I have put a dollar of mortgage lending on; how does that translate into risk-weighted assets? – is not being recalibrated. There is more technical stuff around the edges.

Iain Mackay

There are aspects of how perhaps the PRA may implement aspects of CRD IV. For example, the models that they would approve for utilisation in low-loss-experience portfolios, which predominantly for us are in the Asian markets, may require us either to have an LGD floor or to assess those on the foundational basis as opposed to the internal ratings-based approach. In that case, then, yes, what you would see coming through that size of book would absolutely be impacted by that. But as yet, that is not something that is reflected in these numbers. So it is one of those technical aspects that may or may not come to bear and I would hasten to add that it is more probable that it will come to bear in the first part of next year.

Russell Picot

There is a very important international body of work that the Basel Committee, as you all know, is undertaking: looking at relative capital and risk-weighted assets across the major markets; looking at the balance between standardised and modelled RWAs etc. Clearly we think disclosure has a very important part to play in informing the market about the way HSBC's risk-weighted assets are calculated and the ones we use.

Ian Gordon, Investec Securities UK

Can I ask you to add a few more comments on the North America run-off? Obviously the drag from run-off has diminished but could you just update on expectations around portfolio disposals and impact? Then I have a second one on swap mis-selling.

Iain Mackay

I wish the drag from the run-off of North America had diminished. The revenue impact on run-off in the year was in excess of three quarters of a billion, in terms of the reduction of the size of the portfolio; as well as that, when we disposed of the non-real estate consumer finance loans in the first half of the year, that generated a loss of some $280 million, which is clearly reflected in the revenue line. That being said, the dispositions of defaulted loans, of which we have now completed four tranches, the last two tranches of which were completed on 1 October, have in the round been breakeven or slightly – and when I say slightly, we are talking about a couple of million bucks, so it has pretty much been done at book value, which is a remarkable accomplishment on the part of the team.

Overall, since 30 September last year, the book has declined by about $10 billion. Of that, there was about $3.7 billion of non-real estate; that was unpaid principal balance. There is about another $2.7 billion of unpaid principal balance on defaulted mortgage loans. The team is now working on marketing the tranches that we would expect to dispose of, more than probably in the first half of next year. It is not impossible, but it is unlikely that we would do any more this year because of the operational complexity of doing these transactions with buyers. They are now building a pipeline of, again, about $6 billion of unpaid principal balance that they would expect to be able to dispose of in the first half of next year.

That then goes along with the continued pay-down of the portfolio. However, I should say that pre-payments and pay-down of the portfolio have slowed. Delinquency has dropped. The performance of the book is improving. Delinquency dollars are dropping gradually, which is the first time that has happened in many, many, many quarters. That is encouraging and almost certainly a reflection of improving employment conditions, feeding through to an improvement in property market valuations in the United States. But in terms of pre-payment opportunity, there is still very limited refinancing opportunity for the customers in this book. To the extent we see run-off in the portfolio, it is almost certainly going to be mostly from disposals with charge-offs, but hopefully a declining proportion of charge-offs, then just through the natural maturity realisation of the book, with actually fairly limited pay-downs from a refinancing perspective.

Post the 1 October transactions, we are now sitting on a net-book-value basis just below $30 billion. We would certainly expect, barring something really quite unanticipated in the US economy or housing market – that being said, given the somewhat fraught politics over the budget in the US, never say never,

but we would hope – that conditions would certainly remain as they are, and hopefully continue to improve marginally next year, which would support the disposal of the better part of $6 billion unpaid principal balance. Again, on a net book value by the end of next year, it is not inconceivable that we see this book below $25 billion, or even a little bit lower. Certainly, the target that we talked about back in May of having this book around $20 billion by 2016 is well within our grasp, caveating that simply for something untoward happening in the US economy.

Ian Gordon

Then, on interest-rate swaps, first of all, congratulations on the initiative you took on separating consequential loss payments. I see even Lloyds have now followed you.

Iain Mackay

It seemed sensible, yes.

Ian Gordon

Do you now have any line of sight on the consequential loss? The feedback that you get from claimants and/or the pressure groups is that, notwithstanding your announcement, there are still a few larger cases where the two issues are not being fully separated and none of the banks have so far set out their case or tried to quantify a consequential loss.

Iain Mackay

Probably the best answer for that, Ian, is, on consequential loss, we have done two things. One is the quite public aspect of splitting this into, if there is redress, let us deal with the redress against the criteria that have been agreed with the FCA and get that redress out there.

The question of consequential loss is a really difficult one. What we have done, having gained agreement from the FCA to do this, is we have introduced a second skilled person, a law firm, as you would expect, to work through each file with respect to the question of consequential loss. It is a challenging legal question. Some of the cases are really easy. We have customers out there stretching and there is no evidence to support consequential loss. There are others where there is probably a fairly good argument for that consequential loss. Then the question becomes how you quantify that. There is some objective evidence that can be provided to support any consequential loss that would be remitted.

In terms of operational data coming through in terms of experience of resolving consequential loss cases, there are none, at this point, within our portfolio. I cannot remember the percentage, so I will not put it out there. There are a number of cases coming through, as you would expect, by virtue of the fact that we have appointed a separate skilled person to deal with it, which have consequential loss claims against them. We will deal with the redress first in those cases. Then, through a separate process, which is likely to take longer, we will deal with the consequential loss aspect.

Ian Gordon

Is that change of policy evident in the IMS data? It would appear to be.

Iain Mackay

The increase in the provision is to do with the operational cost of completing the exercise. It is not a reflection of what we expect to happen from a redress perspective. This exercise will take longer. We have appointed a second skilled person and an increase in the reserve is, to the very significant majority of it, for the operational costs associated with completing the review. Like the FCA, or government at least, we would like to have this done as quickly as we can.

Amit Goel, Credit Suisse Securities (Europe) Limited

I wanted to make a couple of clarifications, one from your opening comment on GBM revenues where you mentioned they were a bit slower in October/November. From the call, the comment was that October was in line with the nine month run-rate, so I just wanted to check.

Iain Mackay

Not quite, a little bit slower than that.

Amit Goel

Secondly, I wanted to clarify, in terms of the Jaffe litigation, in the call the comment was that you had a small provision. In the documentation, it comments that you have something in line with your best estimate of cost. Is it a reasonable assumption that you have a provision covering the bottom end of the $1.5 billion to $2.2 billion plus interest range that was suggested a few years back?

Iain Mackay

No. We have provided the range, which has been based on the claims process that was handled through the courts and the possible range within which those claims could fall. The court decision that was handed down in October identified the claims that were to be paid to customers of nearly $2.5 billion before pre-trial interest. Post-trial interest will now accrue. We will post a bond while this case is appealed, but the decision that was handed down was exactly the decision we expected. The one thing that has changed is, with that decision, we are now given leave to appeal the decision that we knew was coming. Our legal evaluation of the strength of our position on this case has not changed. The case has been going on for more than 11 years now. Hopefully it does not go on for another 11 years. But legal counsel has consistently, throughout this process, supported the view that we have a very strong case.

There were a number of challenges as to the judicial process that was followed by the trial judge, which, certainly from a procedural perspective, strengthens our right to appeal. That appeal process will now proceed. We have a small provision and that provision is largely informed by how we may be prepared to settle were the plaintiff to indicate some interest in a settlement process.

Chintan Joshi, Nomura International Plc.

I will start off with a follow up on the North America question. If I look at the fair value difference you have in your 10-Q, it has come down from about 10.8% of risk-weighted assets to about 6.5% of risk-weighted assets year to date. At the start of the year I thought that would be a good way to think about how capital accretive your sales would be, but it has not been because it has come down a lot more than I was expecting. You have given a couple of hundred million in each tranche as the loss that you are taking against book value. Is that how we should think about it, that a tranche is about $750 million with a couple of hundred million losses, so let us call it $200 million?

Iain Mackay

No. On the $3.7 billion unpaid principal of the non-real estate loans, we realised a loss of about $280 million. On the four tranches of defaulted mortgage loans, those have been sold basically within a cat's whisker of breakeven against book value. The tranches have been ranging from $400 million to about $500 million in size.

Chintan Joshi

So the fair value calculations are based on what? What is giving such a big number relative to your real experience?

Iain Mackay

It is a market valuation against our book value. Thinking about this portfolio as a whole, and the difference between the book and market value, if you tried to sell the whole $30 billion today, we would expect the discount to market value to be somewhere between $3.5 billion and $4.2 billion.

Chintan Joshi

Is that liquidity related or is that actual mark to market?

Iain Mackay

That is an approximation of mark to market, which clearly would reflect liquidity, which would reflect discount for volume. We have no intention to sell the whole book because we can get better execution by selling tranches on a due-diligence-by-due-diligence basis. So what the team has done is put in place a competitive bidding process. The files are then given broad access for very detailed due diligence. As a consequence of that, we have then, consistently, on those four defaulted mortgage books, moved pricing from where it started, upwards.

Russell Picot

Those fair values are based on external quotes as a process that the US goes through of seeking to recalibrate, on a regular basis, those fair values.

Iain Mackay

Yes.

Ian Gordon

Is there a PVA sort of approach? If you sold the whole lot you would take a much harsher assumption.

Russell Picot

That is not the way the accounting world works: that you take a $30 billion book and then apply some sort of block discount. Accounting theory says, 'Item by item' which means loan by loan, but in fact what we do is package it up into tranches and then we take that through brokers to get indicative prices. Then we calibrate that back to what we are seeing in the market – because compared to a couple of years ago, we are out there; we have competitive bids – to then recalibrate what we are seeing. PVA is a much more GBM perspective.

Chintan Joshi

Continuing on regulation, you have about $6.5 billion of expected loss; where does it sit and can we expect that to move with disposals?

Russell Picot

Most of it sits in the US.

Chintan Joshi

Year to date, we have seen a reduction of loan balances but the EL has not really changed. It has been pretty flat, so when will it drop?

Iain Mackay

The only way this comes down is with the continued rundown of the exposure – the EAD; you have to reduce the exposure at default.

Jane Leach, Head of Group Regulatory Reporting

Where you have a defaulted book, the parts that are defaulted will tend to attract a lot of expected loss.

Chintan Joshi

But you are only beginning to sell now.

Jane Leach

To the extent that we sell defaulted books, then that will bring that down a lot. The other factor to bear in mind is that, in general, I am not talking specifically about the book, you tend to find that expected loss trends will follow provisioning and accounting trends because it takes a while for loss experience to come through into your models, and therefore into your expected loss calculation. It is worth bearing that in

mind when you look at those results as a whole. That is just a generality. It is the technical way in which it works.

Russell Picot

They are based on downturn LGDs. Where LGDs, on an accounting basis, are improving, the regulatory numbers will not reflect that until you then dispose of the assets.

Chintan Joshi

So we could have a double whammy there: EL's go away, as well as, depending on where you sell, RWAs get off as well.

Russell Picot

Double benefit, do you mean?

Chintan Joshi

Yes. On your NII sensitivity, a lot of your sensitivity sits in the sterling block. You said on the call that you tend to manage subsidiaries on FX-match basis except the equity net investment. Is there any flexibility in your balance sheet management to move those block sensitivities to another currency, if you see yield curves steepening elsewhere? Can you move your sterling block into dollars for any kind of significant impact?

Iain Mackay

We can but we do not. On an entity-by-entity basis we try to strike a reasonable match, both on currency and maturity, across the book. That is obviously not perfect. That is the role of balance sheet management, is really the maturity transformation and then managing the interest rate gap. Balance sheet management is managed within each legal entity, and notwithstanding an imperfect match, the main element of our exposure to capital is the net investment. The net investment is denominated in different currencies, the most significant of which, outside US dollars, are euro and sterling because our other main currencies tend to be fairly closely dollar-linked.

Chintan Joshi

What is the House or Treasury view of when rates go up in the UK?

Iain Mackay

Not before 2015. There was something interesting on Radio 4 this morning, or yesterday; there were a couple of journalists on the phone. The view was that it was quite difficult to move interest rates up in the UK because there was still a household leverage question which would probably cause fairly significant stress; maybe a 50 bps move would not, but a 200 bps or 300 bps move over the next few years would probably cause enormous stress from a household affordability perspective. There is a balancing act, therefore.

The next question is: is much of the recovery that is being driven at the moment being fuelled by mortgage lending, related consumer spending and debt? There is macro data there that I would love to see come from the Bank of England over the course of the coming months as they monitor what is going on from a Help to Buy perspective and in the housing market. If the growth is just coming from leverage within the residential space, then the interest rate equation in the UK and managing, for example, if inflation started move up in the course of the next 18 to 24 months, puts the Governor in an interesting position.

Manus Costello, Autonomous Research LLP

I have a couple of questions on capital. Firstly, in your capital planning, do you assume any counter-cyclical buffer will be applied to HSBC? When you talk about your neutralisation of the scrip etc, would you assume that there would be some sort of counter-cyclical buffer?

Secondly, on the famous CP05, some of your peers have given us some colour, without giving us any numbers necessarily, around the sensitivities for 2A versus 2B: what is going to hit them, what is the more relevant part and why they are different. If you are not going to give us any numbers on it, could you at least talk around some of the sensitivities that you see in the 2A versus 2B debate?

Iain Mackay

On capital planning, we do factor in counter-cyclical buffer considerations, to the extent we can.

Manus Costello

How much?

Iain Mackay

I am not telling you.

On 2A and 2B, there is a consultation paper and the industry has consulted on it. In December, we expect to see, back from the PRA, let us assume, their decisions as to how they respond to any of the consultation that has been provided by the industry. Until we see that, and I do not believe, in December, we will see anything other than the response to CP05/13 because there is still probably the better part of 50% of implementing technical standards from a CRD IV perspective to be actually promulgated, published by the EBA for comment or for implementation by the European Commission. Therefore, in the round on the broader implementation of CRD IV, it is fairly difficult to provide clarity on it when you have not even had line of sight to the RTS or the ITS, at this point in the game.

The industry, and we, have provided detailed feedback on what was proposed within CP05, both with respect to coverage of Pillar 2A/2B requirements, 100% equity and so on, and frankly, we disagree with what was proposed in the consultation paper. I have provided I think a number of compelling arguments as to why what they are proposing does not make a great deal of sense and has attached to it almost certainly unintended consequences for the wider economy, let alone the impact that it might have in the industry, which you can almost set aside. I am intrigued by some of the guidance that has been provided by some of our peer group because it is confusing to me as to how they think they can provide that with any assurance.

Manus Costello

On the 2B requirement, for example, you obviously have a big G-SIFI buffer which helps you, but would you expect your 2B requirement to exceed the G-SIFI buffer plus the capital conservation buffer at this point? That is obviously what one of your peers is saying. On the 2A, another of your peers is saying that they do not think they have a big issue because they do not have a major pension deficit or the pension risk that they bear is lower than peers'. I wondered how you see yourselves fitting into that.

Jane Leach

On 2B, you are comparing, as you say, the G-SIFI buffer and the capital conservation buffer against the 2B. So we would have to be going above 5% on the PRA buffer. We have no guidance on whether that would be the case but, as you say, with the G-SIFI buffer in there, we would have to go above the combination of those two.

There has obviously been a debate around pensions on Pillar 2A, and the debate is around whether on Pillar 2A for pensions should be core tier-1 equity or not, given the nature of the pensions risk. That is something that we have contributed to the debate on. We have put our comments in again to the PRA.

Russell Picot

It is worth noting that at the last actuarial evaluation, the pension fund was 100% funded on technical provisions.

The other perspective on this, which I think makes it very difficult to even begin to talk about numbers, is that there is an important policy question about the relationship between the stress-testing programme that the PRA undoubtedly will seek to implement, and the way that the buffers actually fit together. That

is a very important question, not least as to the scenarios they choose to stress and how it will work. That is why our view is that it is just not appropriate to be making comments when we do not really have a sound basis to do so.

Jane Leach

The buffer's coming in is still in the future. So G-SIFI starts coming in in 2016; counter-cyclical is 2016. So we are looking a little way into the future and PRA are still working on their provisions on this.

Iain Mackay

How the buffers are going to operate is something that CP05/13 did not address. There is an interesting chart that stacked everything up and this PRA buffer was introduced. None of us are particularly clear as to what that PRA buffer is. Is it part of counter-cyclical? Is it part of G-SIFI? What is it? How does it interact? Then, if you drop below a particular buffer, what are the actions that an institution may be required to take, or not take for that matter? Are they really buffers or are they just part of fixed capital requirements? If you drop below any of those buffers and suddenly the PRA turns around and says you cannot distribute dividends, for example, or you cannot grow your business, then they are not buffers anymore. So now you have a hard capital floor, in which case an institution like HSBC would hold some form of management buffer above that to ensure we have protected ourselves against any volatility that we might expect in the capital base just from the normal, ongoing activities of the business.

You can understand the desire of individuals to provide the guidance, but unless you can provide guidance that is meaningful, that you can depend on to some degree, I am not sure it is that helpful to any of you. We have had some fairly interesting conversation with Andrew Bailey recently and Andrew feels as if the market is just over-interpreting what is going on there.

Manus Costello

Will you be able to give guidance for the results in February?

Iain Mackay

It depends where we are from an ITS and RTS perspective. We have this quite interesting challenge that we have to implement CRD IV on 1 January. We are still not going to have a number of RTS and ITS by 1 January, and possibly not even by the end of the first quarter. It would be nice to consider the optimism of having all the RTS and ITS out there to the extent that they are going to be consulted upon and consulted upon, have that reflected upon, finally implementing technical standards available for the industry. But the notion that the industry will be able to affirm on 1 January to comply with CRD IV is a bit of a nonsense.

Russell Picot

Within CRD IV and CRR there are a number of national discretions. We have not yet seen where the PRA intends to exercise national discretions. The expectation would be that by the end of February we will know more. Whether we will have all the answers to these very fundamental questions is not within our control. It is very difficult to predict where we will be. Hopefully we will be some way down that road to give you greater colour.

Iain Mackay

If you are going to editorialise on this, based on nothing other than on track record, we think it is fair to assume that the PRA will be somewhat gold-plated to a raw interpretation application of CRD IV because what they have done for the last four or five years has been, generally speaking, super-equivalent. The extent to which they will continue to be so is what you cannot reasonably assess at this stage.

There are other factors. There is regime change within the regulatory space within the UK, which again is another feature where it is too early to assess what possible impact that may have. It is fair to characterise that, in considering the regulation and the standards of implementation being proposed, we take a conservative view in interpreting that. We take a very forthright view in consulting and providing feedback through the consultation process on first-order as well as, perhaps, unintended second-order impact of such an implementation, and then start building management mitigating actions to deal with a

conservative implementation of it. But we do not take those actions until we have a clear understanding of the actual implementation.

Chirantan Barua, Bernstein

To follow on from that, in a scenario – and all sympathies to you; I totally understand where you are on the capital position – how do you get to your Q4 dividend? What influences it?

Iain Mackay

Let us talk about the clarity that the PRA has provided. After the FPC exercise, which I think still puzzles many of us, what the PRA were quite clear about was that they expected British banks to have end point Basel III common equity Tier 1 of 7% by the end of 2013. At the end of the third quarter we had 10.6% Basel III end point. They also provided guidance to firms individually, which is not in the public space, about where they would expect us to be by the end of 2018. We are today ahead of that position.

What we do not know is the exact impact on our common equity Tier 1 ratio on implementing those technical standards that we will have not seen. There are those that we have seen, that we have consulted on, on which PRA interpretation has not yet been decided. So there is a range of uncertainty that we are dealing with. But within that range of uncertainty, we have a level of confidence based on where we sit today that we can be fairly confident about our ability to progress the dividend.

Chirantan Barua

That is only based on past conversation, you are saying?

Iain Mackay

Yes.

Russell Picot

Our view of capital remains very firmly underpinned in our ability to generate capital profit, through profits, and this quarter absolutely demonstrates our ability to do so.

Iain Mackay

So there is absolutely a range of uncertainty here, and you saw some of that coming through our common equity Tier 1 ratio at the half-year, where we took some of the real impact of some of the PRA's implementation of elements of CRD IV, actually elements that are not even within CRD IV. That range, at least based on what we know so far, is something that may well impact, whether we are sitting above or below 10% from a common equity Tier 1 perspective, but we do not believe impacts where we sit against a 7% minima, even adjusted for FPC adjustments.

So there is a range of uncertainty but the ongoing profit generation of the business, the formation of capital through the operations of the business, plus the capital strength that we sit with today on an end point Basel III basis, gives us a level of confidence which allows us to plan and support dividends. But what it does not give us the ability or confidence to do is to tell you where we think we will end up from a capital perspective, or where we need to end up. It is that uncertainty that influences not the process we will follow, with respect to neutralising the scrip, but the point at which we may be able to neutralise the scrip. We could not take a substantial part of our capital that we would either need to meet regulatory demands or grow the business and neutralise the scrip if we do not know what the end regime looks like. But we will, at the AGM in 2014, seek a resolution from shareholders to enable buybacks, and then through the course of 2014, we will continue to work through the implementation of Basel III, CRD IV, CRR and the PRA interpretation and application of that. Then when there is clarity around the end state, assuming we achieve clarity around the end state, we will then be able to assess our ability to do that. If we assess, as a management team, the ability to neutralise, then the final step will be to seek the PRA's approval to do so.

Andrew has been very clear with us that if you meet the regulatory requirements, you can do with surplus capital as you wish. But we clearly have to meet that regulatory requirement and therefore we need to know what that regulatory requirement is.

Michael Trippitt, Numis Securities Ltd

Good morning. Could you give a bit more of an update on North America on one area: costs? At the investor day you made it clear what the scale of potential cost-cuts need to be done. Could you update us on that?

Sorry to come back to regulation, but on the issue around capital in North America, on the one hand there has always been this issue about the level of stranded capital, but presumably, given the leverage debate in North America, capital stays there, I guess? Could you update us on those two things?

Iain Mackay

On the leverage question, the US bank has a leverage ratio that safely exceeds what is being proposed by the Fed and the FDIC. That is a US calculation. It is a US GAAP with some grossing-up of certain derivative positions but it is still basically a significantly netted calculation that bears little resemblance to that proposed either by the PRA, the Basel Committee on Banking Supervision or CRD IV.

We do carry surplus capital in the US to a very significant degree. We are now subject to CCAR, as many of the other large American banks are. We will make our first submission of a full CCAR process, and the capital plan that is supported by that process, on 6 January next year. As part of that capital plan, we will not request authorisation to dividend any of the surplus capital back to the parent, because I think we can be reasonably assured that, if we did, the capital plan would be rejected. We do not want that capital plan to be rejected. However, provided that we continue to make appropriate progress against the requirements of the deferred prosecution agreement, various cease-and-desist consent orders that apply to the US bank, and that we continue to make the progress on running down the US portfolio, which we have clearly very successfully done over the last couple of years, and continued to improve the overall efficiency and profitability of the US business, which again, we have seen real progress on over the course of this year, then it is not inconceivable that, subject to discussion with the Federal Reserve, we may in actual fact, next year, put in a request for some dividend. We would not put a request for the entire surplus as that would be rejected, but possibly to start flowing some funds back to the parent. But that will be subject very much to us making progress against those things that I have mentioned, as well as trying to read the tea leaves through conversation with the Fed. There is no point putting a plan in that the Fed is going to reject. That happened to poor Citibank last year or the year before, and the adverse consequences of that just are not worth the hassle, to be perfectly honest.

So we have substantial surplus capital in the United States, but our goal will be over the course of not this coming year but the years thereafter, to hopefully work constructively with the Fed to start feeding some of that back to the parent company.

In terms of the overall restructuring of the US business, nothing has changed since the beginning of this year. There are two to three years of work for Irene and the team to do. The focus is on running down the finance company. That is going well. It is on realising profitability within Retail Banking and Wealth Management business, which, on a year-to-date basis, has progressed very significantly compared to where the Retail Bank, excluding the Consumer Finance business, sat this time last year. So the nine-month performance versus the nine months last year has improved significantly

Then we are continuing to build the Commercial Banking franchise with an international focus in the US. That continues. It is building nicely but it will be slow, steady, organic growth, building both the capability through the RMs as well as the building the client base. That client base, I would estimate, will be largely West-Coast and Pacific-Rim-orientated. But to reset the footings of the US business is a piece of work that has already been going on for a couple of years, and will take another two to three years, principally to get the Bank in shape to be a bank that operates much like a Canadian bank or a bank in Hong Kong, for example, or perhaps, more appropriately, comparatively speaking, a bank in somewhere like Singapore or Malaysia, but basically a trade-oriented corporate bank that makes appropriate levels of returns. The team has a lot on their plate but they are doing a good job working through it.

Vivek Raja, Oriel Securities Ltd

Good morning. Sorry to go back to capital again, but I have one further question on that. One of your peers is proceeding with running off their high-risk-intensity assets because essentially they are

concerned about the capital charges that those would attract, particularly in a stress scenario basis. Are there any books of assets that you have, apart from the US CML, which are high risk intensity, which you might be concerned about from a capital-add-on perspective in a stress-test scenario?

Iain Mackay

Yes, indeed. We have always talked about the legacy ABS portfolio sitting in Global Banking and Markets, which the business has progressively worked down over the course of the last two years. It will continue to work down the legacy ABS portfolio. The portfolio actually performs quite well – 'well' in a relative basis; it is not returning its costs of capital, but it is performing as expected, and the role for a specialised team sitting within Samir Assaf's team is to continue to run that down and to take, frankly, every and all opportunities to get out at book value or best, which is really what they have been doing. There is a piece of work where we will attempt to accelerate some of that during 2014, with the same goal. They are high-risk-intensity assets but we think there is a market opportunity that is open to us to accelerate that, largely under the same conditions that we have been doing thus far, which is there or thereabouts, from a breakeven perspective. But in terms of those distress assets within the portfolio, that is it.

I cannot remember the exact risk-weighted-asset number we have against ABS. It is down to mid-thirties. Between what we set on the Consumer Finance portfolio, which is about 85, and about 35 that is sitting in ABS, we are about $120 billion out of our $1.1 trillion of risk-weighted assets, which sits in what we would call legacy or distressed assets that we are running down. The progress that the teams have made in both respects has been better than I would have expected, particularly in the US, but even on the ABS front, Samir's team has done a good job.

Vivek Raja,

Could you provide a sense of what, over the last six months, the market appetite has been for those assets? So how has buyer appetite for those assets changed in the last six months?

Iain Mackay

It has not actually. It has been very steady for the last 18 month; we have been able to just work that book. There are parts of the portfolio where the team is scanning the marketplace to see where the appetite is across different sectors of buyers. When pricing looks reasonably attractive, we have tranches that we can pop into the market and get them out. So it is a slow but steady process but if you were to sit at this time last year, the risk-weighted assets on that book would be about $65 billion, and we have taken it down by about $30 billion.

Vivek Raja,

I also have a question on the levy that you have guided £900 million for this year. That is obviously a substantial uplift on last year. Could you explain why that has gone up so much?

Iain Mackay

The government increased the rate.

Vivek Raja,

Could you just explain how the government sets the prices?

Iain Mackay

Speak to the HMRC; I have no idea. It is a tax that is not a tax. The rate went up. That is why cost has gone up.

Chintan Joshi

What about that guy you pay millions to bring it down?

Iain Mackay

Believe me, he does a great job. He is probably the industry expert on the levy, and he advises HMRC on how to improve it, to be perfectly honest. It is a horribly complex transaction. It is a horribly complex calculation. The costs of implementing it probably outweigh the benefits of the collection of it. They are not collecting what they said they were going to collect, which I think was £2-2.5 billion. Bank balance sheets have reduced significantly and we are sitting at £900 million and we are picking up 45% of this thing, for a bank that works largely outside of the UK. It makes the UK a really attractive place to do business. It is what it is unfortunately.

Yafei Tian, Citi

I have a different question on the GBM result. It is more around if you were to look at the return for risk-weighted assets for the GBM business, it has declined slightly – about 30 bps to 1.7%. Although among the global peers, HSBC is still doing relatively better, could you give us some colour on the future around this business in the coming years?

Iain Mackay

So, on an underlying basis, which excludes the legacy assets that we just described, the return on risk-weighted assets, on a year-to-date basis is 2.6 versus 2.7 on the same basis last year. If you do that including legacy, it is 2.4 versus 2.3 last year, so it has improved.

Yafei Tian, Citi

What about the third quarter?

Iain Mackay

It was 1.7 versus 2 and excluding legacy it was 1.8 versus 2.1. It is a mix in some of the revenues. So, for example, you will have noticed that foreign exchange revenues were down in the third quarter, and that was largely on lower volumes in terms of customer activity. Generally speaking, foreign exchange revenues are high-return, low risk-weighted asset contributors. That is the main driver within the movement in the third quarter versus the second quarter.

Yafei Tian, Citi

Do you expect this to be only in the third quarter or do you expect recovery in the coming quarters?

Iain Mackay

That will be aligned to where foreign exchange revenues perform.

Chirantan Barua

Do you have any thoughts on the India thing that came out yesterday from the Central Bank around subsidiarisation?

Iain Mackay

This has been going on for rather a long time. Yesterday's comments are probably helpful but certainly in terms of how it impacts each individual entity, that will be a conversation that we will have and continue to have with the Reserve Bank of India. India is a market we like a great deal. It has its vagaries like others, perhaps more than certain others. It has any number of challenges but it is a great market which we would like to continue to invest in. If we could open up a bunch more branches in India, we would do like we have done in China. We take every opportunity we can to open banks in China, and I suspect that we would very much the same in India. It is a great market. We would love to play a bigger part of the banking industry. There was an article in the press this morning where foreign banks contribute less than 0.1% of the 92,000 bank branches in India. We have 32 in the country, so we would love to expand. It will be a conversation with the Reserve Bank of India about exactly what it is they require us to do in terms of subsidiarisation, which activities that they may require to be subsidiarised, what conditions apply to it, and what flexibilities are then afforded to us to improve the growth of the business in India.

I cannot really call it early days, because it has being going on for four years, but it will, I am sure, be the case for each bank; it will be an individual-by-individual-institution discussion as to what is required of us.

Chintan Joshi

Just following up on that question, where would you look to grow it – CMB, RBWM or both?

Iain Mackay

In India?

Chintan Joshi

Yes.

Iain Mackay

Certainly starting in 2009, and in 2010 and 2011, we have done a very significant amount cleaning-up and restructuring of Indian business. We closed down our Consumer Finance portfolios. We repositioned the Commercial Banking portfolio. You may recall in 2009 and 2010 we experienced some fairly elevated loan impairment charges coming through Consumer Finance and Commercial. Commercial was particularly with concentrated exposure to the tech industry. We have, over the course of the last few years, rebalanced the Indian portfolio.

There is a higher proportion of collateralised lending within that. There is no Consumer Finance. The vast majority of our profits from the Indian business come from Global Banking and Markets. More than 100% come from Commercial Banking and Global Banking and Markets added together. The Retail Bank is slightly loss-making. There is a continued focus on building profitability within the retail bank. It is a scale business so, with a certain caveat around the type of lending we would do into the Retail Bank, we would certainly grow Retail Banking and Wealth Management but also Commercial Bank and Global Bank and Markets. In terms of growth I would not necessarily focus on any of those three but probably equally across them.

Chintan Joshi

In North America we have seen RWAs fall, even ex the run-off; should that continue for a bit of time as you optimise your CMB there?

Iain Mackay

It is partly CMB but it is more so Global Banking and Markets and repositioning within Global Banking and Markets.

Chintan Joshi

If I look at quarter-on-quarter trends – I do not know the FX that just went but APAC seemed weak ex GBM. It was down 6% on my calculations, quarter on quarter, while Hong Kong was up a similar number, quarter on quarter. I am just trying to gauge the momentum in Hong Kong versus APAC going forward. Those are the markets we need to look at.

Iain Mackay

Hong Kong had a very good quarter. There were a number of markets in the rest of Asia Pacific which had slightly sore quarters. India had a tough quarter for a number of reasons that are fairly well documented and that was certainly reflected in our results. Indonesia was a little bit slower. Malaysia was a little bit slower. Singapore held up pretty well and was flat year over year. That is probably it, but between India, Indonesia and Malaysia in the round, that contributed to a slightly slower quarter. Part of it was risk appetite from our perspective, seeing some of the economic trends and certainly the fairly adverse effect that the talk of tapering had on the Indian economy – it was a little bit of tightening of risk appetite within particularly India and Indonesia.

Chintan Joshi

Should we now feel that it is turning at this point? Do you take that view?

Iain Mackay

Within Peter Wong's portfolio, he has seven priority markets: mainland China, Hong Kong, Indonesia, India, Malaysia, Singapore and Australia. They are still very much focus growth markets but, as you would expect of us, when we see things going on where perhaps the trajectory of that journey is not entirely clear or particularly sustainable, we are likely, from time to time, to tighten things, just as we are likely, from time to time, to take a slightly more aggressive stance. The stance in the third quarter was slightly more conservative. It does not necessarily indicate how we might behave in future quarters.

Chintan Joshi

What was the Hong Kong strength driven by?

Iain Mackay

It was driven by growth in the mortgage book and Commercial Banking.

Sandy Chen, Cenkos Security

I expect you are going to say no, but in forex investigations, can you give us with any more guidance in terms of how we might –

Iain Mackay

Excellent guess, Sandy. It is incredibly early days. We have three names, one of which left us in 2001, one of which left a couple of years ago, and one of which still works for us. That employee has not been suspended. It is just very early days.

Sandy Chen

So there is no way to gauge? You would not compare it to Libor or anything like that.

Iain Mackay

It is far too early.

Russell Picot

You will look forward to reading whatever the note number will be.

Iain Mackay

It will be somewhere in the high thirties or low forties, I expect.

Russell Picot

We will run a book on what number it will happen. But that is where we will give a formal update on where we stand.

Chintan Joshi

You touched upon this earlier. We do not know what the regime change of the PRA means. There is some sense that the hawks from the FPC have gone – King and Tucker have gone. Is there any optimism that this may bring a sense of practicality in their thinking?

Iain Mackay

That is a leading question, is it not? I do not know. I am somewhat reluctant to comment on that Chintan. We have a new governor who is getting his feet under the table. He has demonstrated quite an open and thoughtful approach to how he wants to interact with the banks, which we should probably view as

being constructive and therefore will hopefully engender some optimism. But there is a lot still to do with CRD IV. The PRA implementation of that has a long way still to go. Wait and see.

We have a new governor, who clearly manifests a slightly different attitude towards the banking industry than his predecessor. If we behave sensibly and interact with him responsibly, and if the industry does what the hell it is supposed to do, and stops giving the newspapers and regulators the opportunity to investigate us at every turn, then we should be optimistic. As much of that fate rests in our hands as it does necessarily with those of the regulators.

Jane Leach

There are so many different changes at the moment. So with CRD IV, because that is coming in as legislation rather than as PRA guidance, we have a legislative framework to operate to. The fact that the PRA has less power than it would have done under the old capital regime, so we have that as well as the other changes.

Iain Mackay

As well as ring-fencing and non-ring-fencing.

Russell Picot

The EBA has an important role to play as well.

Tom Rayner

On that final remark on CRD IV, I find it a bit surprising that there is still so much uncertainty – forget the PRA, but on these other technical standards. Does it not all come into law on 1 January? Is it then how you interpret that?

Russell Picot

The EBA will not have completed the hundred-and-something technical standards and guidelines that they are required to do by 1 January. They simply will not have done.

Iain Mackay

You have law but then there is the regulation that implements that law. That is where the EBA has responsibility.

Jane Leach

It all has to go through the European Commission, and there are long processes involved.

Chintan Joshi

Is there anything coming out of the ring-fencing changes on a redraft that worries you? I am sure you have a team there.

Iain Mackay

The Finance Bill is going through the legislative process, and I do not think the industry has done everything it needed to do in terms of consultation through that process. It has gone through a couple of readings in the Commons. It is now through two or three readings in the Lords. I was chatting to one of our lawyers this morning; it needs to go through another couple of readings in the Lords, and it then goes back to the Joint Committee. But it is going through whatever the UK legislative process is now.

Russell Picot

Experience would suggest that you can burn an awful lot of time thinking about every twist and turn along the way, and sometimes you are best served just waiting for the certainty to come through and then think through fully when you find out the final outcome. If you are quite a long way down the road, but there is still a long way to go, that is probably the right thing to do.

Iain Mackay

There is an inevitability to ring-fencing. The shape it takes is what is now in debate.

Iain Mackay

Are there any more questions? We have exhausted you? Excellent. You have certainly exhausted us; I can say that much.

Nick Collier

Thank you very much, everybody.