Edited Transcript

Post-Interim Management Statement 1Q 2014 Meeting with Analysts hosted by Stuart Gulliver, Group Chief Executive and Iain Mackay, Group Finance Director

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Corporate participants
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Nick Collier, Head of Group Investor Relations

Welcome, everybody. I should just do a house keeping introduction. As usual we are connected with Honk Kong, there is some audience there which will be available for phoning in. As usual, please could I ask you, when you want to ask a question, to put your name and organisation out first. This meeting will be recorded, and the transcript will be put up on the website. I would now like to hand over to Iain, to make some introductory comments. Iain, thank you.

Iain Mackay, Group Finance Director

Morning. Thanks, Nick. Welcome, everybody. Slightly different format this time. Stuart, as you can see, has joined us. The reason he's joined is one of the most frequently asked questions that have been put to us over the last six months is about China – rather large topic – and, if there's anybody in this firm who's eminently well qualified to talk about China, it's Stuart. So we put together a few pages that are in front of you, which just pulls together previously published information about China, whether from our own sources or from third party sources and Stuart's going to take a few minutes to walk you through those charts. Any questions you've got, whether on China or any other topic for Stuart, that's great, but he's got to dash at 10.45, so we've got him for about half an hour. So we'll start with a rundown on China, and then we'll take it from there, and, when Stuart bails out, we can dive into anything else – dive into anything while he's here, but you can dive into anything else that you want to address, okay?
Stuart.

Stuart Gulliver, Group Chief Executive

Thanks, Iain. So what we're going to do, if you could turn to slide 3 in the small deck, is, effectively, run through what's our view of China right now; secondly, what our business in China looks like and what's our strategy, because we do get the sense that we've become the kind of macro hedge on China, and that may not be an accurate way of describing our business, or, indeed, a very effective hedge as a macro hedge on China; then, putting those things together, what's our risk appetite for China going forward.

So, if you turn to slide 4 and have a look at our view on China, it's obviously a question we get asked an awful lot right now, and there's no doubt that growth momentum has actually slowed and showed signs of slowing. However, in our view, the longer term trends show that China significantly increases its share of global financial flows over the next several years. If you take absolute growth over the last five years, China has delivered nominal GDP growth of 13.6% over that period, and, in 2013 alone, this meant that nominal GDP growth was 4.9 trillion RMB. When you're looking at the rate of slowing of Chinese growth, one forgets the base that Chinese GDP grew from, and one forgets the fact that, actually, the annual growth is now equivalent to what the entire number was about 15 years ago.

So whilst, in 2014, we expect to see nominal GDP growth of 5.5 trillion RMB, it will still be the third highest year on record. 2010 and 2011 are the previous two high years. If you want to look at that by means of comparison, the US economy is expected to grow in 2014 by about under two-thirds this amount that Chinese GDP is still growing at. One of the main reasons for our confidence in China is that the underlying fundamental drivers for growth all look, to us, to be sustainable.

In trade, China is now the world's largest exporter, and, by 2020, we expect it to account for almost a fifth of all global trade flows. More people are investing in China. It's now the second largest recipient of FDI, and, at the same time, China's specific going out policy has meant it's become the third largest ODI investor, and this is helping to ease cross-border investment flows.

Wealth is continuing to accumulate in China, and, actually, one of the big phenomena I think that will drive HSBC over the next 10 years is that the emergence of the new middle class is entirely coming from emerging markets. The net new growth of middle class – which, as we all know, powers wealth because of demand for pensions, healthcare, schooling; drives also infrastructure demand as an emerging middle class demands a better quality of life – are huge economic factors, and, actually, the significant growth of the middle class will be in the emerging markets over the next 10-15 years, not in the developed world.

Crucially, the Chinese government's also introduced a programme of measures aimed at stabilising the labour market, stimulating growth through greater private sector investment, and, of course, accelerating the internationalisation of the RMB, and the third party plenum we see as being a very critical and watershed moment in terms of an accelerant towards those reforms, and those reforms, we think, are a force for stability, not a sign of weakness in any way, shape or form. Of course, China, again, will test these out with the pilot free trade zones that we've seen announced in Shanghai and, actually, in Qianhai, near Hong Kong.

If you turn to slide 5, and this looks at the macroeconomic outlook, so the latest GDP forecasts were for growth in line with or above the current levels, the full year GDP growth target of 7.4%, driven by the reforms I've just mentioned. One of the reasons for these is China actually has a balanced fiscal account. The overall fiscal deficit was 1.2 trillion RMB, which is equivalent to 2.1% of China's GDP, and is actually comfortably inside the international normative standard, if you look at IFC, World Bank type of statistics, of 3%. Government debt to GDP is 39.43, so under 40%, which is also well inside the international threshold of 60%, and, even if you add all local government debt, the debt to GDP is still substantially lower than most of the G7 countries.

What's also worth bearing in mind is that government debt in China is actually being channelled to infrastructure, and that infrastructure is actually required, so a great deal of that government debt actually ends up in productive investment and productive assets. Now, clearly, local government debt – and individual local governments have high debt levels, and that will need to be worked through, but, as we say, if you consolidate local and federal debt, for want of a better expression, debt to GDP is still quite comfortable.

If we turn now to slide 6, and this is our footprint in China, so our strategic goal is obviously to be the leading foreign bank in mainland China, and that really focuses on cross-border flows, so trade and capital flows between China and the rest of the world, which will get captured through our Global Banking and Markets business and Commercial Banking business, and, to a very limited extent, the banking of that emerging middle class, i.e. the banking of a mass affluent business – so what, for us, would be the Advanced and Premier products within our Retail Banking and Wealth Management. We've consistently talked about a two pronged strategy to this. Number one is our 100% owned subsidiary, which we continue to build out, and, then, secondly, the 19% stake that we hold in Bank of Communications. Now, this shows you, effectively, where the HSBC outlets are, and it's important to just focus on this. So we've got the biggest network of any foreign bank, at 165 – this is HSBC. Hang Seng has another 50, and there's another 24 outlets through the 12 rural banks. 'Rural' is not quite what you might think of as rural, sitting here in the UK. They're rather small towns, as opposed to some Wordsworth type of idyllic rural setting.

Iain Mackay

A couple of million people small.

Stuart Gulliver

Yeah, so rural is like 2 million people type of town, okay, just to get some context, but the 165 we very heavily focused, if you look, in the Yangtze River Delta and the Pearl River Delta, because one of the things we've done with our China strategy – and, actually, we're doing this with Brazil, with India – is to do a city cluster approach, i.e. GDP is not spread thinly across a country, or it's not spread evenly across a country. If you think about what the addressable GDP wallet for a foreign bank like ourselves is, it is actually going to be centred around conurbations where there's manufacturing taking place. It is not the case that we need a branch network that replicates ICBC in order to be competitive for the type of banking that we do. So, therefore, we are very specifically targeting city clusters, and that's why you see a concentration in the Pearl River Delta, which is helped in our case by the existence of CEPA, the Closer Economic Participation Agreement between Hong Kong and the Pearl River Delta, and then also clearly building out round the Yangtze River, which is around the Shanghai piece.

So this city cluster piece, in our view, means that you do not need to think of this in terms of, 'Well, you've got a much smaller branch network than any of the mainland Chinese banks'. That's not the right way to analyse it, because it's focused and, effectively, engineering around city clusters. What we will continue to do, clearly, is open branches as and when we get the opportunity to open branches, but it is, as I say,

fair to say that, probably, we would not need more than 500 branches in order to be able to cover off the addressable GDP in the city clusters that represent the conurbations in which manufacturing takes place, which plays itself into the cross-border capital and trade flows I described, and those city clusters are, by definition, the ones where wealth will be created the fastest, which powers our Retail Banking and Wealth Management business.

So if we then turn to slide 7, this summarises the performance of our business in mainland China, and, obviously, the results have been significantly impacted by the disposal of Ping An, which was completed in the first quarter of 2013, which adds to some volatility around prior year numbers and tracking year on year changes, and, of course, that's true about our results overall. One of the things that's clearly impacted the ability of you all to clearly see what's happening is: we sold 65 businesses, so, therefore, the trailing quarters are always, by definition, messy. I don't think we should, frankly, have not got rid of the 65 businesses, but, clearly, what we're hoping to do – and you saw there's a data pack that Iain and the team actually put online this time round – is to help you all get a better understanding of actually what is going on through the numbers.

Now, if you dig within our organic business in China, that's actually continued to grow, so that HSBC China bank – the 100% owned HSBCN, as we know it – has continued to grow, and we've grown out loans and advances by about 39%, and customer deposits by about 29% over this period, and obviously, we're very, very focused on developing our own business in China. But it's really important, when you're looking at HSBC as a proxy to short if you're negative on China, just to get an extent to which the overall structure in the banking market in mainland China may make that not the best hedge. So, if you look at the total amount of assets held in the Chinese banking market, it now stands at about 130 trillion RMB, so that's about $22 trillion. Well, the US banking sector as a whole holds around $16 trillion of assets, because the US banking sector's developed a bond market. China's still at a stage where banks create most of the credit, but, if you look at the chart, two things really stand out. 45% of the assets are held by the five big Chinese banks. The foreign banks, in total, have less than 2% of total assets in the Chinese banking system, and, actually, we have 0.2%. So, actually, as I say, if you're using us a proxy hedge on China slowing down, there may be a little bit of slippage around that hedge.

So, if we turn then to slide 9, I want to then talk about, 'Well, where do our exposures lie?' So they lie, really, in four areas. So onshore lending: so we've been very selective about lending, in line with our strategy and our overall approach to risk, and I'll talk about that in a moment in a further slide. There's there offshore cross-border lending, and the key principle here is that we've lent to borrowers where they are located, which helps to manage risk; i.e., if you're lending to a Hong Kong company, for business in China, you're lending to them in Hong Kong against their Hong Kong revenues, okay, because you're not assuming that you've got fungibility moving backwards and forwards across border. Offshore cross-border lending also includes our exposure to mainland Chinese corporates listed in Hong Kong, whether they're H shares or red chips, and then the Hong Kong entities dealing into mainland China.

The next exposure is clearly to Chinese banks, and that comes about through two things. It comes about through trade finance; it comes about because we've got to recycle the offshore RMB deposits that we take; and it comes about through the internationalisation of the RMB, and it's different than other banking systems for the following reason. As the RMB internationalises, it's not yet at a stage where you have a China interbank payments system or you have complete fungibility of the number of banks who can clear RMB. So, if you trade dollar euro, there's probably 100 banks that you can take your risk off with, and there's a Continuous Linked Settlement Bank. At this stage, what happens with the RMB is there are, per financial centre, a designated PRC bank, which is the clearing bank. By definition, you therefore end up with exposure to that bank. Those banks are, actually, the big four, and they are effectively state owned, so the way to think about it –and they are state owned – is to think about it as sovereign risk, in essence. As that market develops, that concentration of lending towards mainland Chinese banks will fall away as it becomes a normal type of foreign exchange market, and you have multiple choices of counterparty.

So, if you then go to slide 10, this is basically to give you a kind of idea of how we grew our exposure in China over a series of phases over the last, really, six, seven, eight years. So the first phase, as we open in China – it's a classic banking strategy – is you follow your customers. So, as international customers started to do business in China, whether it's Dow Chemical, Siemens, these kind of names; all

the big Hong Kong developers go north – Swire, Hutchison, Cheung Kong etc. – we follow them into China and bank them into China.

Then, secondly, we sought to extend lending to selected state owned enterprises with international ambitions, so the Chinese oil companies, as they go overseas and start exploring in parts of the Middle East, you then start to bank those guys as they become international. China State Grid has just done big developments or infrastructure projects in Brazil, in Australia. Those are the types of transactions which it's logical for us to be on, because that's part of the trade and capital flow which underpins the valuation of the net worth of why we're in 75 countries. If you're not in Australia or Brazil, you clearly can't be helping China State Grid build the grid in those places.

Then, thirdly, we then started to extend mortgage lending to Premier customers, but bear in mind there are very strict limits from the regulators in China on LTVs; you can't lend more than 75% in China, so don't think of this a sub-prime type of market, or even, actually, as significant a leverage as the UK market allows, so it's a 75% LTV maximum.

And then, lastly, we started to bank privately owned enterprises with international ambitions, so these would be some of the privately held companies that have started to move overseas. Huawei would be a very good example of that. So, overall, the strategy's actually been quite deliberate and quite phased, so, by the end of 2013, we had total loans and advances to customers of $33 billion. Now, it's important to point out, though, within this, we've got no exposure to trust companies, no exposure to local government financing vehicles, and our total exposure to Chinese SMEs is $300 million US.

So, just to conclude, whilst growth momentum in the Chinese economy in terms of GDP has slowed, its GDP is still a very large number, and its rate of growth is still a colossal number. The creation of wealth and the economic growth in China, we think, remains strong, and we think the long term economic trends that we've seen remain valid. We also believe that the third party plenum creates a significant accelerant for market reform, which will help underpin that stability.

We don't, for a second, doubt that there will be bankruptcies, there will be bonds that fail, and there will be an introduction, for want of a better expression, of moral hazard or removal of the Beijing put, but we do not believe that we are significantly exposed to that at HSBC. We have avoided lending, for the reasons I've just set out earlier – but clearly, therefore, we don't have exposure – to steel trading, ship building, solar panels, any of the kind of sectors that clearly are showing stress, at this moment in time. We do believe that we're extremely well-positioned to capture opportunities from the internationalisation of the RMB, which we think is a phenomenal process that will transform both capital markets, foreign investment flows and foreign exchange markets.

We think, also, the growth of free trade zones and urbanisation, and the increased integration with Hong Kong, will provide a huge opportunity for HSBC as well. We actually see a situation where – and this is why we've concentrated a lot of focus on the Pearl River Delta, where the border between Hong Kong and Shenzhen and, therefore, Guangzhou, becomes completely porous, and, at that point in time, our business in Hong Kong has access not to 8 million people, but to 45 million people living in that Pearl River Delta area. There's a high speed railway that will be finished shortly, which will make the journey time between Guangzhou and Hong Kong less than 30 minutes, so you're going to see an opportunity for us, and, actually, other banks based in Hong Kong, to bank a significantly larger population than the one in Hong Kong. They're all Cantonese speakers. The big advantage to us is we can, therefore, staff it out of the 29,000 Cantonese colleagues that we have working for us in Hong Kong.

Actually, clearly, the brand awareness in the Pearl River Delta is very high for HSBC. Our notes have been in circulation there for a very long time. These people are also watching Hong Kong TV, and, if you go to Hong Kong now, the incidence that you'll see on the streets of cars with black number plates, as well as – which are mainland Chinese plates – as well as Hong Kong plates is just everywhere. The border is absolutely already open and porous, and, therefore, actually, the economic opportunity, from a wealth, from a trade point of view, is considerable. Remember, Guangdong is about 110 million people. It's sitting there as roughly 8% of China's population, but it's about 13% of China's GDP, so that's a significant opportunity. Whether you look at that as part of our Hong Kong strategy or our China strategy, a Hong Kong or China opportunity, it's a really significant one for this firm over the next five or seven years.

What we'll also obviously do is continue to very carefully manage our exposure to China. We're acutely aware of the extent to which the Chinese GDP is a major influence for the world generally, and we're also very much aware, given the name as the Hongkong and Shanghai Banking Corporation, that we've become the default proxy whenever there's either good or bad news about China.

So I'm very happy to take questions on this or anything else to do with our strategy results, and, as Iain says, I've got 15 minutes before I need to go.

Iain Mackay

Okay, now, just a reminder, when you do get hold of the mic, if you can give your name and the firm you're with for the benefit of everybody on the telephone, okay?

John-Paul Crutchley, UBS

John-Paul Crutchley from UBS. Stuart, maybe a question the other way round, thinking about Hong Kong and China. I mean, clearly, I can see the opportunities for you in a Chinese context, but also, clearly, the Chinese banks are trying to make inroads into Hong Kong and take market share and build deposit franchises there. I just wondered what your longer term perspective is on that competitive dynamic and how you react from a defensive perspective as well as an aggressive perspective in terms of building out the China business.

Stuart Gulliver

Sure. Look, I mean, the mainland Chinese banks are serious competitors, and, in most instances, are extremely well run, so there's no doubt there's a competitive dynamic there. What I think, though, that we are seeing is that, obviously, the liberalisation of interest rates will impact the profitability of Chinese banks. So the margin pressure that we've seen in recent years I think will start to abate, because the phenomenon you've just described started some years ago, and, actually, there was a period – and you can see it in our own spreads and margins – where, actually, particularly lending margins in Hong Kong got quite squeezed by the Chinese coming in quite aggressively, but, in a way, that's somewhat, now, tampered by two things.

The volatility you saw in the Shanghai Interbank Offered Rate last June, and then a couple of other times last year, has been, actually, quite a significant wake-up call, in terms of the asset liability management that the Chinese banks will face going forward in a regime that liberalises interest rates. Secondly, obviously, a lot of profitability of the Chinese banks has come from, for want of a better expression, the financial repression of fixed deposit rates and fixed lending rates. As those start to move around, there will be opportunities for them to make more money. There'll also be a requirement to be more sophisticated in the way they make that money. I think that, therefore, means that they will be competitors, but rational competitors. Actually, to be honest, we'll always face competitors, absolutely everywhere that we operate. The hope has to be that they face the same competitive and pricing dynamics that you do. The ones that are most difficult to deal against are ones that have a different paradigm of profitability or returns, and I think that that's changed, now, because, it's quite clear from the third party plenum, interest rate liberalisation will take place, and it's quite clear, from what PBOC did last year, that they will drive short term interest rates, where they require to drive them, from their own policy point of view. Those are completely new things that stop the competition, if you like, being irrational from a price point of view.

Chris Wheeler, Mediobanca

It's Chris Wheeler from Mediobanca. Stuart, could you just talk a little bit about BoCom within the context of what you've talked about here, perhaps talk about where the relationship has gone since you started it and where it will go as you go towards these 500 branches that you say could be the sort of broad target you set?

Stuart Gulliver

Sure. So it's always going to be a two-pronged approach. So we have the strategic stake in Bank of Communications, and, if you look at what's been achieved so far, there's quite a strong credit card JV

was built up, which now has a reasonably large number of cards in circulation, so I think of the order of 35 million or something similar. What we're now looking to do – and there's been a formal agreement, signed by myself and President Niu, to focus on the going overseas policy that China has set, because the advantage to BoCom of HSBC is we're in 75 countries, so, for BoCom, it gets access to an international network. For us, obviously, BoCom has got much deeper relations with the state owned enterprises than, frankly, any foreign bank is likely to get.

Things like the China State Grid stuff is evidence of that cooperation, so there's teams been identified in both banks to actually track and work on: how do we look to finance Chinese enterprises going overseas? Because that's the advantage that we bring to BoCom, and, frankly, that's one of the advantages they bring to us. So what we are acutely aware of – and so is the senior management of BoCom – is that we'll need to demonstrate to you all that only 19% of BoCom brings business opportunities to the two banks that would not otherwise exist, for the simple reason that you can buy BoCom directly, because it's a listed company now.

Obviously, when we first invested, it wasn't listed, so it was one of the only ways to get exposure to it. Now it's listed, we're absolutely aware, and so are they, that we need to show this, and, actually, there's willingness on both sides, and we're starting to track towards that. As I say, there was a formal agreement that was put in place in 2013 to do just this. So, even when, therefore, we have that kind of branch network, I don't see that as – that is – let me be clear: that is not a strategy to undermine the shareholding that we have in BoCom. We see both as completely consistent with one another. One isn't designed to displace the other. I think, for the time being, we would want to run with both. I think the Chinese authorities see our relationship with BoCom as a bit of a poster child, actually, for Sino-foreign cooperation in the financial services industry, and we continue to have a constructive relationship with the senior management of BoCom. .

Chintan Joshi, Nomura International Plc.

Thank you. Chintan Joshi, Nomura. Stuart, you addressed the China macro bear case that gets put against HSBC. There are two other ones that go along with it, one being an EM bear case and the effects China will have on APAC and, therefore, the Group revenues, and the other one, which JP touched upon, is the profitability in Hong Kong is very high relative to Chinese banks coming in and, so, logically, that should come to a similar ground, which means profitability pressures in Hong Kong. If you could address those two as well.

Stuart Gulliver

Sure, so the last one, I think, is solved by what I was just saying earlier. There may well be profitability pressure in Hong Kong, but if we get to actually address – you know, if you look at Guangzhou, Dongguan, Shenzhen, Hong Kong, and you go from a market of 8 million people to 45 million people, where actually the per capita income is not that much different, then I actually think that that volume variance should take care of any margin compression that takes place.

On a general EM and China's impact on EM generally, I think you have to be more precise in your analysis, because Japanese QE is definitely benefiting Malaysia, Thailand and Indonesia, because, actually, the Japanese clearly won't invest in China because of the foreign policy issues that exist around the islands or vice versa. So what Japanese QE is clearly doing is investing in the Japanese supply chain. So, whilst you might say that a slowdown in China – and, as I say, we are talking about 7.4% GDP growth, so it's the kind of slowdown that most of us would be rather happy to have – it's nevertheless being offset by the fact that the Japanese are supporting the Japanese manufacturers, so there's a good deal of Japanese money going into Indonesia's car companies; into Malaysia's electrical companies; Thailand, the car companies. So, really, we don't see a weakness in their GDP growth particularly.

If you look elsewhere, India, I would suggest – and you, clearly, will know more about this than me, that, as we move through the election, actually, the market's already moving to, probably, capital flowing back into India, actually not in the other direction. So Brazil, I can see – Brazil is a closed economy, so I can see little correlation between China and actually what goes on in Brazil. Mexico is a NAFTA beneficiary, and is a beneficiary of what's happening in the United States.

This idea that there's huge correlation is not necessarily borne out by what we're seeing. Specifically there'll be some supply chain countries undoubtedly impacted but, as I say, across Asia at the moment you're not seeing a significant slowdown that comes to a crisis level, which is what you're kind of describing here. You can be sure that the regulators will obviously stress us on China, emerging markets, Europe and the UK.

Vincent Chang, Goldman Sachs

Hi. I have two questions. One is on Hang Seng Bank. How do you coordinate with Hang Seng Bank in China, if any and, on a group level, how does Industrial Bank fit into the group's strategy in China?

Stuart Gulliver

We reclassified Industrial Bank as available for sale, so I think that's sufficient clarity. As for Hang Seng, obviously Hang Seng has a substantial free float and a substantial listing, and has substantial minority shareholders. We do not direct Hang Seng. We have bought representation; we own 63%, but Hang Seng is not 100% owned. There is coordination but there is not direction.

Again, Hang Seng's obvious strengths are in the Pearl River Delta. If you think about Hang Seng's business mix, which tends to be very domestic Hong Kong, those types of SMEs tend to have manufacturing just across the border, which you're very familiar with, Vincent. It's a kind of extension of what Hang Seng does in Hong Kong; it'll do it in the Pearl River Delta, and that really has no competitive overlap with HSBC at all. We coordinate, but we absolutely do not control.

Vincent Chang

Okay, thank you.

Sandy Chen, Cenkos Securities

Stuart, you've been talking about RMB internationalisation and I was just wondering if you could expand a bit more on that. I guess RMB flow is a good way of thinking about it, both in terms of trade and investment, and the HSBC share of that. I could imagine that you could see both capturing significantly greater than the 0.2% or whatever you're talking about, in terms of RMB flows, and using that to build up a customer base.

Stuart Gulliver

You're absolutely right. We should have greater growth opportunity from the internationalisation of the RMB than simply competing in the domestic market to lend RMB to things in China, which is what the 0.2% shows. Actually, the big jump in the amount of trade that's denominated in RMB, which has gone from something like 6% in 2010 to now 16%, and we think will soon reach 30% of China's annual trade, will present a significant opportunity both to finance that, because we've got a bigger country network than any mainland Chinese bank. I think ICBC's at 35-36. Remember, to finance trade you generally need to be on both ends of the trade corridor.

The second thing is, from a foreign exchange trading point of view and then from a bond issuance point of view, all of that will continue to pick up. As more and more trade is denominated in RMB, more and more pools of RMB will wash up into Europe, into London, and therefore there will be corporate treasuries looking for assets to invest that RMB in. Remember we did an RMB bond listed in London ourselves about a year ago. That was placed mostly into Euro Stoxx 500, European corporate treasuries in Europe, because they had working balances that effectively were idle that they wanted to get a return on. All of that kind of generates business opportunities. You're right: there shouldn't be the same prescribed market share constraints.

Sandy Chen

Any comment or guidance in terms of share or–?

Stuart Gulliver

It's hard at this moment in time to get a feel for it, but we do believe it's a big opportunity for us.

Alastair Ryan, Bank of America Merrill Lynch

Thanks, good morning. On Hong Kong again, I know it's hard to disaggregate from the mainland, but to the degree the HKMA was effectively last year in slowing the property market, that looks like it's more or less washed through. Sales are a bit better year to date and there have also been a lot of moving parts in trade finance and what have you. A lot of your peers are growing extremely quickly and have come to a screeching halt as the HKMA has had a word or two. Could you just characterise your growth picture for HSBC right now, within Hong Kong?

Stuart Gulliver

Look, the trade finance stuff that came to a screaming halt was usance DCs. Actually, we've always had very strict controls over proper documentation and actually cargo to avoid accommodation finance. The controls at the HKMA may put in place have very little exposure on our trade finance, because we were issuing usance DCs where RMB has been deposited in China against a dollar borrowing in Hong Kong, which was the interest rate arbitrage, but where there's actually a cargo, as opposed to it simply being the arbitrage on the interest rates, which was fuelling a lot of the volume that the HKMA and PBoC – to be fair, the PBoC is clearly on to those as well – have removed. It has virtually no impact on us, because we've always been looking for, 'Where's your cargo? Where's your bill of loading? What's actually coming through?'

In terms of the property stuff, we kept our market share of new mortgages. Actually, we slightly increased our market share of new mortgages but, obviously, volumes dropped over a period where the constraints on property purchases came through, but we've seen no – we've been very determined to make sure – that there's been no erosion of market share of that property that's getting financed. As you say, most of that is working through the system.

Ultimately, the property issue in Hong Kong will be resolved by the longer-term policies the Hong Kong Government has in terms of supply. Short term, what they're obviously determined to do is to stop the property market becoming unaffordable for Hong Kong people by money flows coming in from China. The way they've tackled it is sensible, because that isn't financed. You've got to deal with it with stamp duty, with capital gains tax, because it's not being financed by the banking systems, so it doesn't matter where you put the LTVs or what risk-weighted assets; it's not actually being financed. They've been successful in actually deterring that. From our point of view, same market share and, on the trade finance piece, we were always with strict controls around usance DC to make sure there's cargo. There's time for one last.

Manus Costello, Autonomous Research

Just moving away from the focus on China, if I may for a second, many of us have just come from a presentation by Barclays talking about a major retrenchment in the amount of capital they're committing towards the investment bank and they blame structural issues as well as cyclical issues. I wonder if anything has changed in your thinking over the last couple of years about capital allocation to GBM or whether or not that framework you set out for us about a year ago, in terms of incremental capital allocation, is absolutely the way you're going to continue going forwards.

Stuart Gulliver

It's the second. First of all, we ran all the businesses, as you know, through five filters back in 2011 and added a six filter on financial crime risk. Then very much a year ago we set out how we would cycle capital into businesses. If you look at our revenues in Global Banking and Markets, if you actually look at the kind of underlying business, we're down 1% first quarter versus first quarter. We have a very different business, and we've always been saying this, than BarCap.

If you look at 2006/2007, we made about US$5-6 billion PBT from Global Banking and Markets. We now make about 10. It's really market share, because it's clearly not prop, with the Volcker Rule and so on and so forth. I think that the shape of our business – yes, we will continue to fine-tune it, but we had a pretty good first quarter in Global Banking and Markets, so there's no need for us to do anything like Barclays has done. I can't comment on Barclays; I can only comment on HSBC.

Iain Mackay

Stuart, thanks very much indeed.

Stuart Gulliver

Thank you.

Chintan Joshi, Nomura International

Just picking up where Stuart left off, it's a very strong growth message that he wanted to give but, if I look at underlying revenue trends, if I look at the quarterly run rate, Q1 is pretty much in line on a clean basis. What I call 'clean' is backing out the significant items that you've given and also going from reported to underlying PBT. Then I look at North America, it's down; LatAm down; Europe down in traditional banking, not looking at GBM. When do we see this message translate into some revenue momentum? What is it that is holding some of these businesses back?

Iain Mackay

Certainly when you talk about the China approach, Stuart put a timeline on this. This doesn't happen quarter over quarter; this happens year over year. To take specifically our global businesses, if you look at Retail Bank Wealth Management, we've taken some very deliberate actions over the course of the last couple of years, not only to reposition where we do business. At the beginning of 2011, we were doing Retail Bank Wealth Management in over 60 countries; it's now 44.

In addition to that, when we look at the quality of those revenues, and this is perhaps more of a specific focus on UK – also we are seeing some of the behaviours that have been manifest from a conduct agenda perspective in the UK migrating elsewhere in the world – we've taken action with respect to not only how we structure the business, but how we incentivise our frontline staff within Retail Bank Wealth Management. In the first quarter, in January of 2013, we repositioned incentives within the Wealth Management business to not be commission-based, to move it to a balanced scorecard approach based on customer outcomes and treating customers fairly. The connotation is you were not treating customers fairly in the past, but what we are absolutely focused on is removing from the incentive process a purely volume-orientated approach to selling financial products, so it is fit, suitability, so on and so forth. We did that in January of 2013 and, clearly, as people adapted away from being able to do a very mathematical, arithmetical calculation about 'I've sold this much; I get paid this,' they had to go to a balanced scored, which is more judgmentally orientated. It had an adverse impact on revenues. That's begun to come back as people have built faith in the fact that the balanced scorecard system actually works and that they get paid quarterly what they used to get paid on a monthly rhythm.

In January of this year, we extended that to all of Retail Bank Wealth Management. The main markets of Hong Kong, the UK, Brazil, I think, are probably the three main markets from a retail perspective, the US being the other main market. In the UK, Hong Kong and US, we've started to see the revenues come back. Brazil, we've not. In Brazil, every single other bank is very commission-driven. Although not the entire market has followed us on this approach, we certainly view this in the longer term as leading to improved quality of earnings within the Retail Bank Wealth Management business, in terms of being able to respond to enquiries from regulators around the conduct agenda, building much more confidence around what we do with the customer focus protecting the revenue, being able to defend that revenue stream and not to have to give it back in the future. It's showing signs of working well, but it is not necessarily showing signs of everybody else in the market following on. There is some pressure in the UK market for people to follow, but it would be fair to say that we're probably leading in this respect.

In Retail Bank Wealth Management, in addition to repositioning the portfolio, disposing of businesses and restructuring the business, we've had some very specific actions around changing the quality of those revenues for the longer term. It's still going to take some time for that to work its way through, as John Flint continues to work with the sales force in the business to move that on.

On Global Banking and Markets, the story's pretty clear: the business model stands up pretty robustly, even when, particularly in the fixed income side, the rest of the market is under a little bit more pressure. To be able to deliver 1% down ex-balance sheet management revenues in the first quarter, in the kind of trading conditions that we saw, again goes to the somewhat robust and resilient nature of the banking model there.

On the Commercial Banking front, what we have seen is volumes holding reasonably well but, as we talked about for most of last year, margin pressure. Although we've seen that margin pressure ease in Hong Kong and Asia, it hasn't recovered. It certainly hasn't recovered to the levels it was at the end of 2012, but it has in the latter part, the last quarter of last year and first of this, stabilised. I'm not going to talk about recovery, but stabilised. Although volumes have been fairly consistent, we've clearly seen margin pressure.

Volumes have also held reasonably good in the European market but, again, there's margin pressure there. What we've particularly seen are the benefits in the UK in particular around, for example, the Funding for Lending Scheme for some of our competition, which perhaps find themselves in a slightly better funding position now and are more aggressive. Although overall net interest margin in the UK held up reasonably well, we did see compression on the asset spreads, but somewhat compensated on the liability side of the balance sheet.

Then when you go to Private Bank, it's principally about repositioning the European business, both around tax transparency, the type of customers we want, the kind of markets that we will operate. That repositioning of the Private Bank will continue certainly the whole way through 2014. I think it's going well; I think the team's got a real handle on what they're doing, but the revenues within the Private Bank are going to be under pressure for, I would suspect, the remainder of this year.

Chintan Joshi

For RBWM, should we treat this quarter as having some adverse seasonality compared to previous years?

Iain Mackay

You've seen seasonality year over year in our revenues. I wouldn't assume that any of the seasonality is going to necessarily be different from previous years. We've got a first quarter that generally is strong, not only in Global Banking and Markets but, to a lesser extent, CMB and Retail Banking and Wealth Management. We would expect to see seasonality remain fairly consistent.

The possible offsetting factor to that is, as the frontline staff become more adapted and used to the new incentive schemes in place, the impact on the workforce will stabilise and then I think the impact on revenue should follow.

Tracy Yu, Deutsche Bank

I have a question relating to the RMB exchange rate movement. Do you see much impact on your Hong Kong and Asia business from the recent RMB depreciation, especially for the FX-related income and trade finance? If RMB heads for a more sustained decline, how would that change your risk appetite and growth strategy? Thank you.

Iain Mackay

No, we haven't. If anything, the very fact that some actions have led to renminbi being a two-way bet, as opposed to a one-way bet, has perhaps increased some of the volatility around that currency and generally that volatility creates opportunity for the bank, in terms of managing the customer flow. In

terms of the overall impact on our customer base and the levels of activity, it would be also fair to say that we haven't particularly seen any adverse effect. What I think we're witnessing, and Stuart talked about this as being really a phenomenal change, is the notion of liberalisation within the renminbi and behaviour within that currency will progressively become more similar to the behaviour that we see across other currencies that are more perhaps freely traded. The upside from our perspective is that continued liberalisation of the currency.

Perhaps another upside coming from it is now a building awareness within many of our customers' minds that it has to be viewed in a manner consistent with how they would trade FX more generally, and that it's not a one-way bet. From our standpoint, we are extremely well positioned with respect to ongoing developments within renminbi and would expect to continue to benefit from that, but will there be some short-term volatility through the cycle? Again, we'd absolutely expect to see that.

Stephen Andrews, UBS

I just wanted to follow up on Manus's question on GBM, which I thought was a good one. There's obviously a lot of change going on in the investment banking space in fixed income. Your return on risk-weighted asset target at the pre-tax level of 2-2.2%, if we look at the risk-weighted assets attributed to that division, obviously they jump significantly in Q1 up to about 550 billion, up about 30% on the transition to CRD IV. Was this completely in line with your thinking two years ago when you were laying out the business plan for this division? Do you still think that 2-2.2% is achievable with risk-weighted assets 30% higher than they were last year? That's really the thrust of my question.

Iain Mackay

The return on risk-weighted assets in the first quarter for Global Banking and Markets was 2.4%. In terms of how we thought about this in 2011 when we put this – I wouldn't necessarily say 'put this capital allocation methodology together', put perhaps some refinements around it and specific measures in place – that was done with full awareness that the impact of Basel III on the business, relative to its three peer businesses, would be the most significant. It has in fact proven to experience the most significant impact from the implementation of CRD IV, with a lot of movements between deductions from capital to risk-weighted assets, movements between IRBA to standardised, standardised to IRBA. It is a veritable moving feast.

What is fair to say is that Samir and the team continue to be under quite continuous pressure from Stuart and myself around ensuring that the business moves capital across its various product lines to be able to continue to achieve the 2-2.2% return in risk-weighted assets, taking into consideration the changes coming through the regulatory environment. Yes, it clearly puts some headwind in the equation for Global Banking and Markets. Thus far, they've been fairly adept and in fact are probably more practised than any of our global businesses at this point, in terms of responding to regulatory change as it relates to the risk-weighted assets environment and weightings, and the treatment of some of their products.

That being said, there's a lot more to come in terms of implementation of the Dodd-Frank Act and, frankly, probably more to come in terms of implementation of CRD IV, the role of central clearing parties and so on and so forth. This business is under – I don't want to make it overly dramatic, but possibly 'constant attack' would be a good way of describing it. At the same time, the business has built a fairly robust capability in terms of analysing the impact of new regulation and then adapting their business model. There's no question about it: there are stresses and strains there. We don't think the capital allocation methodology, the approach to managing the business, has by any stretch of the imagination broken down, but it is under constant review.

Stephen Andrews

Thanks. Can I just follow up on that? The 550 billion is obviously a step-up to a new run rate for risk-weighted assets in that division. Is there much you can do over the next 12 or 18 months in terms of mitigation or should we just be growing off that 550 base?

Iain Mackay

Certainly the impact that we saw in the first quarter was largely around implementation of CRD IV elements. There are absolutely mitigation actions that the business can take; it can choose not to do certain kinds of business, when in actual fact the business has taken a number of such decisions over the course of the last 18 months or so and has either significantly reduced exposure to those businesses or, in actual fact, closed them completely. I wouldn't take anything for granted in terms of mitigating actions. From the outset, we've said, as regulation changes, we'll review the performance of each business against the six criteria that we set out. There, very specifically, are the returns and profitability of the business. If it breaches the point where we believe no manner and no extent of management action would sustain the profitability of the model, we would then seriously contemplate exiting that line of business. Thus far, there have been no significant lines of business exited, but they are under constant review.

Stephen Andrews

In summary, where we stand today, there are no plans at all to do another strategic review of GBM. It's just notable that all the other divisions have sort of borne the brunt of the restructuring so far, and in GBM it's been much less visible.

Iain Mackay

I think it's less visible probably because it's been run as a global business for six or seven years now. Some of the structural change that you've seen impacting Retail Banking and Wealth Management, Private Banking and Commercial Banking wasn't, in our view, required in the case of Global Banking and Markets, because it was run as a global business. It had a lot of the MI capabilities that we've had to create for the other businesses already in place. It had many of the measurement and management supervisory capabilities already in place but, as it relates to the returns equation within that business, it's under the same degree of scrutiny as all the other businesses. In fact, I'd say quite the opposite: it is under constant review and we're continuously looking for ways to refine the performance of the business.

Stephen Andrews

Thanks very much, Iain.

Iain Mackay

There was another question from Hong Kong I think. We'll take that and then move back to the room.

Junhua Mao, CICC

I have two questions. The first is about your views on China. You mentioned that the Debt to GDP is not high compared with G7 countries. However, it is rising quickly and that has caused a lot of concerns. I wonder why you think it's not risky for China to have substantial relative increase in the ratio of Credit to GDP. The second question is about your relationship with BoCom– China has been in the process of another run of financial reform, especially in SOE financial institutions. Do you have any intention to further increase your stake in BoCom if China could continue to deepen its SOE reform? Thank you.

Iain Mackay

At the moment our degree of ownership of BoCom is limited to 20%. We own 19.03%. So, no – we've got no intention to increase our shareholding because, frankly, we couldn't. Even if reform were to take place and industry would allow us to, unless we could in actual fact gain control of it we don't see any benefit in owning 25% versus owning 19%. I think the only question that presides structurally is even if we were able to own 51% could we truly control and integrate that business effectively and into HSBC networks. So no, although we clearly view the BoCom relationship as being strategic – and Stuart described some of the work that we do in more detail – there are no intentions at the moment to deepen the extent of ownership in that enterprise, limited largely by regulation.

On your first point, I don't think we are. Perhaps we didn't convey that clearly. I don't think we're particularly concerned at all about the relative burden of debt to GDP, for example, within China. I think we see it as being, if anything, favourably positioned compared to some of its G7 partners, or competitors, perhaps. So no, I don't think there's anything particularly concerning on that front. I mean there are a set of ratios economically that our economist colleagues continue to monitor on a regular basis, but I think generally speaking we view China favourably in terms of how it stacks up comparatively and relatively to its other G8 partners.

Alistair Ryan, Bank of America Merrill Lynch

Thanks, costs, if I may, please, actually went down in the first quarter, which is something that doesn't happen a lot in the banks. Were there any of the litigation compliance issues that are outstanding loom larger and just didn't happen in the first quarter? There's always a bit of seasonality in your costs into the end of the year, so even excluding the levy and what-have-you, that number might tend to grow, but whether that reduction is kind of a robust lead indicator net of other things going through, but also the underlying reductions you've talked about over the last two or three strategy days. Thanks.

Iain Mackay

Thanks, Alistair. On the litigation point, what was disclosed in Note 43 of the financials remains valid. There's been no significant developments at this point in terms of substance around the facts and circumstances in each case. The only thing that has moved forward, which I think is a positive development, is that we now have a court date for our appeals being heard on Jaffe, which is the large securities case class action case in the US. That will be heard at the end of this month. Whether we actually get a decision from that; impossible to say because it's a 20-minute presentation by each of the Defendant and Plaintiff Attorney to the Appeals Panel in the Seventh Circuit in Chicago, and they will take that away and reflect on the arguments and examine the case, and we'll get a decision at some point and we'll take it from there. But whether it's within weeks or months, we don't know, and what comes from that decision we can't necessarily predict at this moment either. That, in terms of substantive impact on the financial performance of the business is the largest impact that's out there that we know of at the moment, and we've disclosed those details in Note 43. So in the facts, nothing's changed in that regard.

In terms of costs overall, I think you come back to the revenue equation, recognising the amount of restructuring that we've done across our business, some really quite rigorous demands that we're placing on our teams around our engagement with customers as well as balancing that out with the engagement with the regulators, and perhaps most particularly in terms of the customer impact, making sure that we meet the requirements of the DPA. We recognise that the revenue outlook is a tough one; it's challenging, whether it's driven by economic factors or whether it's driven by HSBC idiosyncrasies. As a consequence of that, the operating rigour on costs will remain constant, if in actual fact not become even more intensive over the course of the coming quarters. I think the teams did a good job in the first quarter of managing costs effectively. The challenge that is placed on them constantly is not only realising sustainable saves, of which we realised 275 million in the first quarter, but booking more of those sustainable saves on the bottom line of the income statement.

So we've done a lot of reinvestment in risk and compliance, in technology, in business process capability and product introduction. I mean specific areas of investment, payments and cash management, global trade and receivables financing, continued liberalisation of the renminbi as examples. But that reinvestment ratio across, broadly speaking, three categories of technology processing people also has to be balanced out against some of the challenges within the operating environment. And the focus is trying to take more of that sustainable save to the bottom line and make sure that we have just rigorous controls across those areas of expenditure which are more easily controllable. So this is a not a good example because it's not a particularly large element of our expenditure, but just simply setting people more stretching targets and managing travel and entertainment expenses, and working more effectively with our vendors across the technology space, the travel space, and making sure that we take the benefits of organising as a global organisation through four global businesses, eleven global functions, and turn that into leverage with our vendor base, and again realising more savings from that.

So the discipline; I think we've built good discipline over the last two or three years, but there's a lot more to do. We still have massive amounts of simplification to do from customer facing processes the whole

way back through the organisation, and notwithstanding the progress of the last three years, there's an awful lot still to do. So there's progress been made. The discipline's going to remain there. We got a good first quarter in terms of cost management; the focus is on trying to replicate that. But to your point, I think some of the seasonality was, particularly fourth quarter, frankly after was just poor discipline around year-end. There was a bit of a traditional approach to year-end spring cleaning which we've sort of tried to bang into people's heads that they're going to do every month. Get your accruals right, make sure that we're managing the invoices properly, managing the vendor relationships properly, and when we build the right visibility of the cost base and just get that – frankly book-keeping done properly, to reflect appropriately the actual cost actions that are taking place.

So really, the only seasonality that I want to see coming out of the cost line is the seasonality that goes with activity within the business. So when the revenue goes up, I'm quite happy to see – whether it's FTE or the compensation line goes with it, but I don't really want to see that happening when we don't have the revenue developing in the same direction. And then I suspect we will, for the foreseeable future, deal with the fourth quarter impact of the levy.

Andrew Coombes, Citi

Just a couple of questions; one on disclosure and then one on the US run-off portfolio. Just firstly on disclosure, given that we've had Stuart present on your concerns there. HSBC is being used as a macro hedge in China, and we've talked today about concerns about long-term profitability erosion in Hong Kong, knock-on impact from a slowdown in the mainland to Hong Kong volumes. Can you just explain a little bit more why the decision was taken to combine the Hong Kong and rest of Asia pack reporting segments? That was my first question.

The second question is returning to the US run-off portfolio. Very good progress there in terms of RWA reduction during the quarter. A good chunk of that was due to model updates, but also due to a shift in quality rather than an underlying reduction in assets. So I was just wondering, going forward from here, I think you guided to about another 40% reduction in assets by 2016 on the post results conference call. Presumably we should be thinking about RWAs trending not just in line with that, but presumably there is more – you'd have expected there'd have been a larger decline due to the quality, but also potentially small model updates there as well.

Iain Mackay

There's a slight challenge on that last point; let me take that secondarily. So there have been model updates, so what was in effect – so what did we call the model update? The GEN2 model was accepted by the PRA, which was helpful. But even within that model, what we are bound by is a downturn PD and LGD, which means you live with your loss given default and probability of default at the lowest point in the curve through the duration of the model. So in terms of moving down the risk rated assets is really getting the exposure default off, which means reducing the unpaid principal balances, okay? So you will actually see a fairly high correlation between reduction and book value and risk rated assets, barring other changes to the model. So although quality is clearly very, very helpful in terms of impacting the loan impairment charge line, unless Jane or Russell kick me under the table here, it doesn't really change the risk related asset equation, the correlation between book value and EAD as the correlation to look at as opposed to LGD and probability of default, okay? But the outlook is reasonably encouraging in the US from that standpoint. Certainly the data over the last six quarters has demonstrated that.

On Hong Kong, guys, don't read too much into this. We are reporting the way the business – the way we manage it. It's actually a requirement of international financial reporting standards that we do that. And the person who runs Asia Pacific is Peter Wong, and the team based in Asia. If anything, we've got greater consistency now between how we report the European business and how we report the Asian business. We don't break out the UK separately. In the Annual Report and Accounts and the Interim Report, we do give you UK and Hong Kong specific information. We'll continue to do that. We may continue to refine the data pack to provide you a little bit more information on those jurisdictions, but this isn't a game of hide and seek we're playing with you. What we're doing is aligning around IFRS 8 to report the business, how in actual fact the management structure is run up. And we sit down at the group management board with Stuart and the rest of the management team every month, we look at Europe, we look at Asia, we look at Middle East and North Africa. We also look at the global businesses within each of those regions. Those are the dimensions.

Peter doesn't come in and sit down and specifically reel off the Hong Kong unless there's something very notable within Hong Kong. And as has ever been the case, which will continue to be the case, if there's something specific going on within Hong Kong or any other market in the world which has a telling impact on the financial results or helps people understand the performance of the business, then we'll disclose that.

Christopher Manners, Morgan Stanley

Just a couple of questions, if I may. So two questions: firstly on impairment charges, obviously great result on the quarter, benefitted a little bit from write-backs, but also showing the tighter risk discipline coming through, just about 32 basis points in the first quarter. I was trying to work out, should that be a sustainable run rate for – is that going to take up, because I think on the results call I got a little bit confused by the answer.

And the second question was on risk weighted assets and model changes. Standards were saying that they had a model change coming from – I think they were talking about K-factors and momentum models that was going to cost them another sort of 30 basis points or so. Is that something that…

Iain Mackay

I don't know what they're talking about. K-factors? What are K-factors?

Russel Picot, Chief Accounting Officer

Is that the market risk, at a wild guess?

Iain Mackay

We've got RNIV; we've got PVA, right? But that's it. So there are two things out there, but those are known to the market generally. On LICs, sorry for confusing during the call, but if you look at LICs as a percentage of average gross loans and advances, the last five quarters – the first quarter of last year, 46 basis points. Second and third quarters, 77 basis points and 64 respectively; I'll talk about those in a moment. Fourth quarter 2013, 44 basis points, and this quarter 32 basis points. I think you all appreciate that second and third quarter last year was impacted by Brazil and Mexico, most notably. I think certainly from the data we've seen coming through the fourth quarter of last year and the first quarter of this, we're certainly more confident about how we are positioned both with respect to accounting for restructured loans in Brazil, and in terms of the overall credit quality within the consumer retail and business banking books within Brazil. In Mexico we were very significantly impacted by some alignment around accounting policy matters, but more notably, the provision for low income housing constructors, where again our level of coverage sits at somewhat over 50% out of total exposure, so just over US$ 600 million.

The restructuring of those businesses continues. As you would expect, rigorous review of them each and every quarter; no changes made to the coverage that we had in the first quarter, but we keep that under review. So I wouldn't necessarily say that 32 basis points is utterly sustainable. We didn't have large recoveries coming through the first quarter of 2014, although we did have some quite significant recoveries in 2013. So I'm not going to pick a number, but you can easily do the correlation, making allowance for Brazil and Mexico, across what you've seen for four or five quarters now. And what I can say, you know, I'm not going to give you a number, but what I can say is that we see credit quality remaining consistent. You go across each of the regions, each of the global businesses; there's nothing out there just now that either by country or by industrial sector that we're crawling all over and saying, 'This one really worries us.' I mean there are obviously a few countries which we are particularly attentive to; one which we've been attentive to for years now – or it feels like years – which is Egypt.

We talked last year about being very focused on markets like Indonesia and India, in the wake of the impact of some of the US dollar easing or QE easing in the second half of last year, and then probably for the last six to nine months we've been particularly focused on just making sure our Turkish customers and their exposures both across bank and non-bank are properly managed there. But again, remarkably, Egypt, we've had no bad debts fall through on our corporate portfolio in Egypt over the course of the last 18 months. Certainly nothing of significance, and thus far it remains reasonably so the case also in India

and Indonesia and Turkey, but they are four of those markets which we monitor closely. And I think it's fair to say Latin America gets more than its fair share of scrutiny on credit costs, and has done.

Christopher J Wheeler, Mediobanca Spa

Just perhaps two questions; one is a follow-up, which I had marked here, which is page 20 of your Q1 results. I wanted to get an idea on the commercial banking; that's where you saw a particular dive in provisions. I just wondered, that 197, would you give us any clue as to what you thought the underlying might be? I know there was some benefit there of Mexican CMB, and I think European CMB coming down, but obviously that's where there's a marked dip, and where we'll all be scratching our heads. That's the first question.

The second question really takes us to the US cross-border tax issue. Obviously we know now the DOJ in the States seems to be getting more hawkish, and the size of the fines are moving up towards sort of 10% of undisclosed assets, and maybe more. Have you disclosed what your undisclosed AUM were in the US in terms of your discussions with the DOJ? Because obviously Credit Suisse, UBS, [inaudible] and so on have done. And the second thing is, can you explain to us what you would like the outcome to be if eventually you get to an outcome regarding either the settlement or pleading guilty? And given how that relates to your existing DPA, would you be able to keep those two things separate or are you concerned they would come together and give you more issues than you would like?

Iain Mackay

Unless it's in Note 43, I don't believe we have disclosed specifically those assets under management that would be subject to scrutiny by the Department of Justice, because in the round, the Department of Justice interaction with HSBC, we imagine it's similar to that with other banks in terms of identifying specific customers. There's nothing wrong with holding a bank account in Switzerland. What's wrong with it is, a) not disclosing it on your US tax return, or for that matter your British tax return; and reporting the income that you generate from those accounts. And what the DOJ is focused on is obviously the inability – not inability – the unwillingness of the Swiss authorities to allow banks to report to the Department of Justice those customers who bank with them, for the US Government then to go and scrutinise whether or not those customers have specifically disclosed on their returns the existence of those accounts.

I think our appreciation is, at the moment, that we're sort of tail-end Charlie in the process. They're going after the big guys first. In terms of – rhetoric is probably not the right description because I suspect there's more to this than rhetoric, but there is a lot of discussion in terms of, you know, 'We're not really interested in just fines now, we want to prosecute somebody.' This probably is largely driven by the fact that lots of fines and penalties have been dished out; nobody's been prosecuted. No institution has been prosecuted, or at least as it relates to this particular matter, very few individuals have been specifically prosecuted at this point. So in terms of predicting – well we would clearly like this to turn out is: one, for them to do the investigative work and conclude that there has been no misdeeds on the part of HSBC or any of our employees. Absent that, a good outcome would be for any shortcomings and internal controls or disclosures in that respect would be an appropriately placed fine. That would be a good outcome. If they choose to go down the path of prosecuting others, and they find wrongdoings within HSBC of any significance, then I think it increases the risk of a desire to prosecute the entity within HSBC which would be responsible, and for that matter, any individuals. But at this point that's impossible to say.

Everything we know about this case we've disclosed in Note 43 of the financials for you. It's really impossible to assess, but I do think what we have is a deferred prosecution agreement, and it is deferred. It's not a non-prosecution agreement. And to comply with it, we clearly have to ensure that the matter for which we were prosecuted, which was the failure to have in place proper internal controls around anti-money laundering controls and sanctions. We now address on a global scale on a global scale, and that's really where a lot of our focus and investment is orientated. However, one of those requirements is that we don't breach any federal law. And if in actual fact findings of the Swiss case were to suggest that we had, again, it would create more pressure for the prosecutor and the Attorney General in particular for prosecution as opposed to deferred prosecution or fines and penalties, so we just have to work through it, and it's going to have to be facts and circumstances based.

Christopher Wheeler

And on the CMB LICs; any of the underlying numbers?

Iain Mackay

One second. Not really. I mean it's really driven by just lower LICs in Europe. I suspect coming more so from improving credit conditions.
Well, yeah, that is absolutely the case. For three quarters, it was impacted by the home constructors in Mexico, which book straight to CMB.

Tom Rayner, Exane BNP Paribas

Thanks Iain. When you said on the results call you were going to sit tight and manage capital in relation to the stack that you put on your slide 10, can you just add a bit of colour around what you mean? I mean, at 10.8, it's pretty much in line with where you think the go to plus the management buffer is, so are you going to manage it fairly flat, and as and when things change, if they change, you will react in line with any confirmation of other tightening of policy? Is that what you were suggesting by that comment?

Iain Mackay

It is. What this chart says – and it probably goes – best to go to the chart – the box in the middle of that chart. What we know is what's really on the left-hand side of this page. So we know what the 4.5 has been – the common equity tier 1 CRD IV minimum requirement becomes 4.5% next year. What we know is our Pillar 2A – we also know the pillar 2A is dynamic. We've just carried that across base, as it's currently assessed within CET1 being 56% of the total, and that will be assessed based on the PRA's view of HSBC and Pillar 2A type risks associated with the firm. What we then obviously just lay out is the phasing that we know, with regard to the capital conservation buffer and the G-SIB buffer, okay? What we don't know, at this point, and what the PRA is not clarifying, is how they intend to implement, over what timeframe – if, in fact, at all – they intend to implement a countercyclical buffer, which really is needs-driven – at least, that's what Basel III and CRD IV would indicate – or sectoral capital requirements which, again, there's a lot of national discretion around those two elements. Again, one would expect it would be driven by needs-based, in terms of trying to address particular areas of either overheating or – difficult to say 'cooling' because what can they do with a buffer that's not already in place?

Then the last element which we believe will be informed by the results of the stress test later this year, going into next year, is the PRA buffer, and how that PRA buffer interacts with countercyclical, sectoral capital requirements and the Pillar 2A requirements. So, today, we are generating capital strongly, quarter over quarter, from the profitability of the business. We've absorbed, effectively, the effects of implementing CRD IV thus far. We sit with a common equity tier 1 ratio endpoint of 10.8, transitional of 10.7, and we look at that as representing almost two times, in regulatory capital supply, almost two times our economic capital demand.

So the notion of building more capital against the risk equation of the business, driven by anything other than regulatory capital requirements, to us, doesn't seem very sensible. We have a very small management buffer of about 50 bps, and it is there for really only one reason: and that is for some translation FX volatility that we see coming through both capital and risk-weighted assets, based on the assets and liabilities and the capital sitting within the businesses denominated in those currencies. So, for example, in the first quarter, we saw weakening of the Brazilian real, Indonesian rupiah, Indian rupee against the US dollar, but we saw very significant strengthening of sterling against the dollar, so the net impact, in our capital ratio, in the first quarter, was about 3 bps, and we hold a buffer of about 50 bps for that purpose. But we have got – given the amount of buffers and the capital strength that we've got, we have no intention, until we've got greater clarity around countercyclical sectoral capital requirements and the PRA buffer, to build capital beyond what we think the business – just to keep in pace with what we think regulatory capital requirements are.

Tom Rayner

Okay, thanks. I understand that, but I guess the risk of assuming zero, until such a time it's been confirmed otherwise, is some of your decisions on pricing certain products, the businesses you mention

where you may or may not want to stay, and, even, I guess, your dividend policy, at some point, because it might be a few years off, but you've got to get there if you're told you've got to get there – I guess the risk is that you suddenly have to, sort of, put your foot down and catch up at a later date. I just wonder, as a management team –

Iain Mackay

So there is a profile there between now and 2020, right?

Participant

But they might use the buffer or the stress test to kind of bring forward that phasing period, because they won't let you phase the deductions, so are you sure they'll let you phase the buffers?

Iain Mackay

The only thing they've indicated is that they won't, okay? So we've got very clear phasing around countercyclical and G-SIB, right? Now, what they could introduce – but, again, led to believe, but not written down anywhere – but they would introduce progressively, as needs, countercyclical and sectoral capital requirements, but the notion that they could introduce, tomorrow, a 300 bps countercyclical buffer without utterly crashing the British economy doesn't seem particularly likely. So, when you look at the rate of capital accretion from the business, our view is that, both from a leverage ratio perspective and from a common equity tier 1 standpoint, any new capital requirements that may be introduced, from time to time, will have some timeline of phasing associated with it. For that reason, it gives us confidence that, from the capital generation of the business, we're able to continue to build progressive dividends, as we've done for the last three years, and fully expect to continue to do so, and that, should incremental capital requirements be reduced beyond those which we've got clear line of sight to, given the capital generation ability, we would be able to deal with that.

Now, when you come back to the dividend point, we have very, very, very robust distributable reserves, which, even within a short period of time – [inaudible] short period of time of two to three years, over which period we may have to build capital, again, provided the dynamics and the quantification of that is reasonable, we don't, at this point, see it having a significantly adverse effect on dividend. But what we do obviously have a concern around – and this we will continue to revisit – that we set a return-on-equity target of 12-15%, based on an initially core tier 1 transitioning to common equity tier 1 endpoint of 10%, give or take. Sitting at 10.7-10.8%, we're considerably above that level, and, it therefore impacts our ability, in the current interest rate environment, to generate a return on equity of 12%. We can see a pathway to 12% based on the capital outlook that we've got. If that capital outlook were to increase significantly, then we would have to reassess the capacity of the – which businesses we do, so we go back to the five/six filters – which businesses we do and the capacity of those businesses to generate returns on risk-weighted assets and returns on equity in the 12-15% range.

But we'll deal with that when we've got something to deal with. When you talk about pricing, again, the nature of our portfolios tend to be short dated. We don't have a big infrastructure portfolio with 18-, 20-, 30-year loans out there. There's just no incentive within the banking system to do that now. The vast majority of our book of business is three years or less, and, therefore, pricing decisions taken today have got a relatively short shelf life, but what we are absolutely doing is challenging the businesses to price with full knowledge of the known capital profile over the next few years.

Vivek Raja, Oriel Securities Limited

Thank you. It's Vivek Raja from Oriel Securities. I had a question about the CCAR. I just wondered if you could explain what exactly the Fed's issues were with your CCAR, and whether that's changed your thinking on the fungibility of capital out of North America, whether there's any read across from your experience of the Fed in terms of the other stress tests that you'll be going through this year in Europe and the UK.

Iain Mackay

Yep, so, to be clear, as I'm sure you'll appreciate, there's at least two elements – two known elements to the CCAR. One is quantitative, which DFAST, and the second is qualitative, which is CCAR. DFAST, which is the quantitative element, we passed, and were, in actual fact, the strongest capital bank of all 30 tested – not surprising given we've got a capital base of 27% of risk-weighted assets in the US. On the CCAR element, the reason for failure was process: the consistency with which we pulled together the capital planning process for the different businesses in the US; the consistency and reliability of data models; ensuring that… In fact, one of the things they complimented us for was the level of challenge from the board of directors and from the supervisory and governance bodies, so they liked the governance, but what they want is greater consistency coming from each of the businesses.

Now, part of the challenge there is, all of the businesses in the US are quite different. You've got a runoff sub-prime portfolio; you've got a broker dealer; you've got a US bank, to name three, so driving consistency through the models is something we have to work on. To be clear, when we submitted our CCAR in January, beginning of January last year, we self-disclosed areas where we knew we had more work to do to build a sustainable CCAR process, and our view – knowing that we had to do that, because it's a massive step up from CapR, which we'd done in 13 – or 12 for 13 – to CCAR – 13 for a 14 submission – is massive, so we knew it was a huge body of work to complete. We got a lot of it done. There's more to be done, but what we knew we had not completed, we self-disclosed as being, 'This is an ongoing body of work which will continue to improve the process.' We were hopeful that that self-disclosure would get us through a pass. It didn't. They didn't object to any of our capital actions. In fact, they didn't object, in substance, to the plan, but they required improvements in the process, and that's what we're now working on.

The read-across to the concurrent – the PRA or the EBA is that our lessons learned from CCAR is the ease with which we can derive data from our management systems and format them to the way that either the Fed, the PRA, the EBA wants them, because… I think everybody's challenged with this in differing degrees, because how we – the fields we use to manage data often don't align with the fields, for example, in the Firm Data Submission Framework that the PRA is looking for. So, broadly speaking, lessons learned is ensuring we've got flexibility, in terms of deriving data from our management systems to format it for purposes of submission for stress testing in whichever jurisdiction; that there's accuracy, governance and control over that data; that the models that are used – and a lot of this is very model-driven – have got validation behind them, good documentation to support them; that the areas of judgment that we exercise are well-documented and the assumptions clearly laid out and supportable.

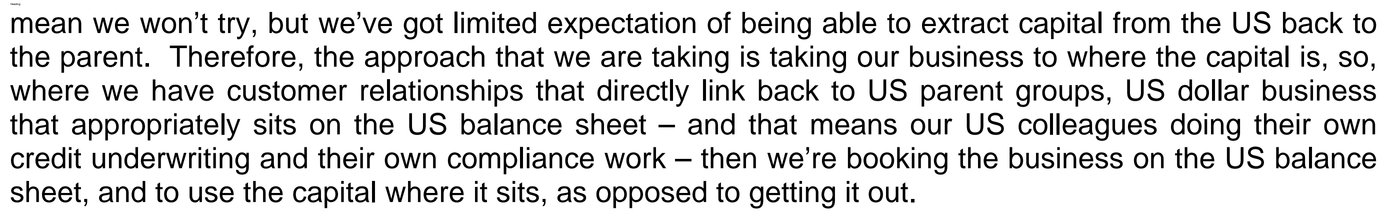
So there are clearly lessons from CCAR which we'll deploy within the PRA concurrent. I think what's important to know is that both CCAR and, more importantly, PRA are very much in the development process. I mean, PRA are in the very early stages, in our view, of developing their approach to stress-testing, and it has changed dramatically over the last 12 months. What the Fed had developed, they'd developed over four or five years. So the Bank of England doesn't say they're going to go to something like CCAR, but, sitting in our shoes, it feels as if that's pretty much where they're headed, so there are lessons to be learned.

Vivek Raja

Does it change your thoughts at all on the fungibility of capital?

Iain Mackay

Well, no, it doesn't, because I have no views on the fungibility of capital with the United States, because our capital is tied up there for reasons… Now, CCAR makes it… Had we passed CCAR this year, probably somewhat to the chagrin of the Fed, one of the conversations we'd have had with them during the year was: dividend from the parent – from the US business back to the parent. Having failed, there's no way we can even start that conversation. Had we even started it, I suspect we wouldn't have been successful. Three reasons: the existence of the DPA – nothing to do with capital management, but, in extremis, you could see their argument for keeping the capital there. The second element is: they've always been clear that they wanted to see a reliable, sustainable profitability pattern within the US bank. There's been good progress in that over the last two years, but there's more to do. The third element was continued progress in the run-off of the sub-prime portfolio, which, clearly, there has been very significant progress made on. But, I think, from our standpoint, we have limited expectation – doesn't



mean we won't try, but we've got limited expectation of being able to extract capital from the US back to the parent. Therefore, the approach that we are taking is taking our business to where the capital is, so, where we have customer relationships that directly link back to US parent groups, US dollar business that appropriately sits on the US balance sheet – and that means our US colleagues doing their own credit underwriting and their own compliance work – then we're booking the business on the US balance sheet, and to use the capital where it sits, as opposed to getting it out.

Okay, right, I think that's about all we've got time for. Thanks very much for your time. We'll continue the dialogue. Thank you.