Edited Transcript

Interim Management Statement 3Q 2014

Conference call with investors and analysts

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Corporate participants:
Stuart Gulliver, Group Chief Executive
Iain Mackay, Group Finance Director

HSBC

Stuart Gulliver, Group Chief Executive

Thanks very much, good evening from Hong Kong, and welcome to our third quarter results call for analysts and investors. With me today is Iain, who's going to talk through the detailed financial performance, and we'll both take questions, but let me start by pulling out a few highlights.

Reported profit before tax for the third quarter was $79 million higher than the third quarter of 2013, and our underlying profit before tax, excluding significant items, was up by $873 million. Excluding significant items, we increased underlying profit before tax in all of our global businesses. Revenue continued to grow in Commercial Banking, dominated by our home markets of Hong Kong and the United Kingdom. Global Banking and Markets contributed a strong revenue performance, and Global Private Banking has now attracted $10 billion of net new money in areas targeted for growth since the start of the year. Meanwhile, the remodelling of Retail Banking and Wealth Management and Global Private Banking remains ongoing.

Loan impairment charges were also lower, but operating expenses were up for three principal reasons. One, we continued to build essential infrastructure to deliver against our risk and compliance commitments, and fulfil our regulatory obligations. Secondly, we experienced cost inflation, particularly in Asia and Latin America, and lastly, there were a number of significant items, including the settlement with the US Federal Housing Finance Agency, a provision for the UK FCA investigation into foreign exchange, and additional provisions for UK customer redress. Finally, we maintained both a strong balance sheet and robust capital ratios over the quarter. I'm now going to hand over to Iain to go through the details.

Iain Mackay, Group Finance Director

Thanks, Stuart. For this third quarter, reported profit before tax was $4.6 billion, compared to $4.5 billion in the third quarter of 2013. Underlying profit before tax was $4.4 billion, compared to $5 billion. This included the adverse movements of $1.5 billion on significant items, which I'll come back to shortly.

For the first nine months of the year, reported profit before tax was $16.9 billion, compared to $18.6 billion in the prior year period. Underlying profit before tax was $17 billion, compared to $18 billion last year, also affected by a number of significant items. You'll find a lot more detail on the underlying adjustments and significant items in the appendix to the presentation. Looking at some key metrics, the reported return on average, ordinary shareholders' equity was 9.5%. Our cost efficiency ratio was 62.5%. On an underlying basis, we had a negative jaws of 9.2%. The advances to deposit ratio was broadly unchanged at 73.7%, and our common equity tier one capital ratio on an end point basis was 11.4%, reflecting a strong capital position.

The next slide shows the breakdown of profit before tax for the third quarter and preceding six quarters, separating underlying adjustments and significant items. As you can see, there were $2.2 billion of significant items in the third quarter of this year. This included a charge of $550 million in the US relating to a settlement agreement with the Federal Housing Finance Agency; provision of around $380 million for the UK FCA investigation into foreign exchange; an impairment of $271 million on our investment in Industrial Bank, and a provision for UK customer redress programmes of $701 million, which included additional PPI provisions of $589 million. Excluding underlying adjustments and significant items, profit before tax for the quarter increased by $873 million compared to the prior year, driven by higher revenue and lower loan impairment charges, partly offset by higher operating expenses.

Higher revenue of $547 million was driven primarily by Global Banking and Markets and Commercial Banking. The increase in Global Banking and Markets reflected increased client activity in foreign exchange and equities, while Commercial Banking growth was driven by our home markets of Hong Kong and the UK. Loan impairment charges of $842 million were lower, notably in Europe and North America, whilst higher costs of $570 million in part reflected inflation and increased risk compliance, and related costs.

Now, the main themes on revenue. This chart shows the global business revenue for the first nine months of 2014, after adjusting for underlying and significant items. Revenue in Principal Retail Banking and Wealth Management was broadly unchanged, with a reduction in personal lending revenue offset mostly by higher net interest income from current accounts, savings, and deposits, mainly in Europe and

Asia. Revenue from our Retail Banking and Wealth Management US runoff portfolio was down by $431 million following loan sales and lower average balances. We grew revenue in Commercial Banking by $676 million, or 6%, due to higher net interest income driven by average lending deposit growth in Hong Kong and rising average deposit balances and wider lending spreads in the UK. We also grew revenue from higher term lending fees in the UK.

Whilst lending spreads were narrower compared with the first nine months of 2013, spreads in the first nine months of 2014 were broadly unchanged from the start of the year. In Global Banking and Markets, excluding legacy credit, revenue increased by $146 million. This was driven partly by increased client flows in equities and growth in deposit balances in payments in cash management. Revenue was also higher in principal investments. Capital financing was broadly unchanged, as the effects of increased volumes and market share gains across a product were offset by spread and fee compression. By contrast, foreign exchange revenue decreased, due to lower market volatility and reduced client flows, though volumes improved in the third quarter. In addition, balance sheet management revenue fell in line with our expectations. Global Private Banking attracted positive net new money of $10 billion in areas that we've targeted for growth, including our home and priority markets and the high net worth client segment. However, Global Private Banking revenue fell by 13% as we continued to reposition this business.

This next slide shows the sustained growth in our customer lending over the preceding seven quarters, a period in which we've been running off our CML portfolio and making disposals of non-strategic assets. On a constant currency basis, lending increased by $56 billion since the start of the year, particularly in Global Banking and Markets and Commercial Banking in Asia and Europe. Loans and advances also grew in Principal Retail Banking and Wealth Management . In the current quarter, loan growth was primarily driven by Commercial Banking, most notably in our home markets of the UK and Hong Kong. Net interest margin has been broadly stable throughout the year to date.

Underlying loan impairment charges were down by $2 billion to $2.6 billion for the first nine months of the year, compared to the same period in 2013. The ratio of loan impairment charges to average gross loans and advances to customers fell to 34 basis points from 64 in the prior year period. This was mainly due to declines in Europe, North America, and Latin America. In Asia, the ratio remained broadly unchanged at 15 basis points, compared to the prior year period. Loan impairment charges in Europe fell by $1 billion; this reflects lower individually assessed impairments in Commercial Banking in the UK, and lower individually assessed impairments and higher net releases of credit risk provisions on available-for-sale asset-backed securities in Global Banking and Markets.

North America was $593 million lower, reflecting reduced levels of new impaired loans and delinquency in the CML portfolio, as well as lower lending balances from the continued run-off in loan sales. Loan impairment charges in Latin America were $369 million lower, mainly in Brazil and Mexico. In Brazil, this primarily reflected model changes and revisions for restructured loans made in 2013, partly offset by an individual impairment in Global Banking and Markets. In Mexico, loan impairment charges were lower, due to reduced individually assessed impairments in Commercial Banking, particularly relating to home-builders.

On operating expenses – again, separating out the underlying adjustments and significant items – we saw an increase of $1.3 billion, or 5%, in part reflecting increased risk compliance, and related costs. This includes global standards and the broader risk and regulatory reform programme being undertaken across the industry to build the necessary infrastructure to meet today's enhanced compliance standards. This is in addition to meeting the obligations of multiple stress tests across different jurisdictions and structural reform.

Looking at the key drivers by global business, Principal Retail Banking and Wealth Management was up $798 million, mainly in Latin America and Asia. This was driven by higher staff costs, reflecting inflationary pressures and increased investments, and risk and compliance, together with a levy of $111 million for the UK Financial Services Compensation Scheme. Commercial Banking was up by $393 million; again, driven by inflation and investment in staff to support revenue growth in Latin America and Asia, and Global Banking and Markets was up by $551 million, in part reflecting increased spending on risk, global standards, information technology, and regulatory support. Against this, the continued run-off of the US portfolio reduced costs by $205 million. In addition, we generated sustainable savings of nearly $900 million for the first nine months of the year.

Finally, for capital, we generated 13 basis points of capital in the third quarter. Allowing for foreign exchange, our common equity tier one transitional ratio of 11.2% was consistent with the previous period, and our end point ratio of 11.4% was up, compared to 11.3% at the half-year. As a reminder, when reflecting on your modelling for the full year, you should already know that our capital ratio at the year-end will reflect the deduction of our fourth interim dividend, in line with the requirements of CRD IV. This is a change from 2014, when we were still operating under the previous regulatory regime when the fourth interim dividend was reflected in the capital ratio in the first quarter of the succeeding year. We expect this technical change to negatively impact our common equity tier one ratio. In addition, the fourth quarter will also include the bank levy, which we currently estimate to be around 10 basis points for the year.

Now, let me hand back to Stuart.

Stuart Gulliver

Thanks, Iain. So, to recap, a good revenue performance in Global Banking and Markets; increased revenue in Commercial Banking; $10 billion of net new money in Global Private Banking since the start of the year; ongoing remodelling of Retail Banking and Wealth Management and Global Private Banking ; sustained growth in customer lending; lower loan impairment charges, notably in Europe and North America; but increased operating expenses due to risk compliance and related costs, inflation, and a number of significant items. So, overall, we remain highly capital-generative and profitable, and we remain confident that we will deliver a progressive dividend. We'll now be happy to take your questions.

Questions & Answers

Alastair Ryan, Bank of America

Thank you. Good evening. A couple, if I may. First, thank you for the volume growth figures, which sort of demand that I ask whether now that margins have stabilised and loans are growing 6% or 7%, that there's a sort of pace of revenue growth you have in mind, and whether that should be clearly above cost growth to get back to your mid-50s cost-income target over time. And then secondly, now that leverage has landed, you look better capitalised than ever. Any thoughts about how progressive the dividend might be under those circumstances? Thank you.

Stuart Gulliver

Okay. So, look, I'll start and then Iain, I'm sure, will add far more accuracy. So, look: the fact of the matter is that I think that the operating costs to run a global bank of our size and scale today are higher than they were a year or two years ago. So notwithstanding the fact that we should be able to see continued growth in revenue coming from the increases in loans and advances that we've seen, and that may well cause the jaws to tighten back up from, obviously, the unacceptable -9%, we think, actually, the cost efficiency ratio is more likely to be in the high 50s, because I think the cost of running a global bank is higher than it was previously.

If you look at just the headcount that we've added in compliance and regulation since I became Group CEO, it gives you an idea about what the cost now is to run of these things. So we had 1,730 people – this is just compliance, okay – in 2010, end of. We're now at 6,700 or thereabouts, and probably finish the year closer to 7,000, and I think that that's, frankly, a fixed cost of running this business model. As you say, we are starting – and continue to throw off significant amounts of cash, and we continue to add to our capital ratios, and we continue to be able to support a dividend. So I don't think it invalidates the business model; I just think the costs of running this business model are higher than they were before. So, actually, what you've just suggested will probably get us back into the high 50s, but won't get us to the mid-50s.

Yes, we continue to add to capital, but obviously, we still have uncertainty around the output of the PRA stress test, and we also need some clarity around TLAC, and therefore we are going to have to be – I think, continue to be rather mealy-mouthed about what progressive actually means at this moment in time, even though you're right to say we're sitting here at 11.4.

Iain Mackay

I think Stuart's right on the money there. I think there's a couple of areas on the reg front. The leverage ratio, as you quite rightly pointed out, I think probably strikes a reasonable balance between the dual objectives that the FPC and the PRA have around finance stability and supporting economic growth. So that was certainly encouraging, and I think it's fair to say that we find our self well positioned in that regard.

The TLAC is an area where I think everybody's a little bit in the dark. We'll hopefully learn considerably more about that as Brisbane unfolds later this month, and then I think we are, and the industry's led to believe, that there'll be a sort of consultation and a detailed QIS conducted, over the succeeding months, which will work us through what that actually means for a deposit funded bank working off a multiple-point-of-entry approach to resolution.

And the last, by no means least element, which Stuart referred to in terms of the stress test, is principally a consultation around the PRA buffer, which I think we'll, you know, hopefully see if not later this year, early in January in terms of how the PRA is reflecting on that. What we assume to be an idiosyncratic risk assessment that would be applied to each firm. So as we get through that, again I think we are hopeful that that will provide us greater clarity around capital requirements, and then allow us to be hopefully considerably more clear about what progressive dividend actually means. But there's a little bit more work to be done in this space.

Alastair Ryan

Thank you. Can I just come back to quite fulsome answers on regulatory challenges and cost challenges. Could I encourage you at all to say any more about the revenue?

Stuart Gulliver

No. I don't think we really want to give a kind of guidance on revenue growth. You can see the growth in loans and advances. Given that we believe our underwriting standards are reasonably good, they should hopefully lead not to higher loan impairment charges but higher revenue going forward. And, you know, we continue to be reasonably optimistic about what we think Chinese GDP will be, UK GDP will be. In Commercial Banking there was revenue growth in the UK, in Hong Kong, also in China and Germany, so that was, you know, reasonably widespread. But I don't really want to give you a kind of forecast on numbers as to where revenue growth will be.

But what you can see, Alastair, is that, we've turned the corner in terms of growing year on year loans and advances. Commercial Banking's got good momentum. Our Global Banking markets model is differentiated. We had a good third quarter in Foreign Exchange, though year to date 9 months on 9 months it's still lagging. But there was a good catch up in the third quarter. Equities is – which we've invested in over the last couple or three years – is having a very good year. And, you know, our Retail Banking Wealth Management business, which is going through substantial change – remember we changed all the commission structures, re-priced a lot of stuff, is again picking up momentum. So I don't want to get drawn to a percentage forecast, but we, as I signaled at the half year, I think some of the revenue headwinds are falling away, and you can see that in the progress that's coming through

Alastair Ryan

Thank you very much.

Iain Mackay

Thanks Alastair. Can we take the next one please?

Chintan Joshi, Nomura

Good morning. I have two questions. One on costs and one on capital. On costs just to push you a little bit further. If I back out the significant items and the on-credit movement this quarter, if I use your mid-50s – let's call it 55% – cost income ratio, I get a rate of about 8.9 billion, and you've reported a clean number of something like 9.4 billion. So is this the kind of cost saving that you can work towards, despite regulatory pressures going forward? And then one on capital.

Iain Mackay

So I think – Chintan, good morning to you. I think there's, as Stuart said, we – and you see it coming through these numbers. There is continued upward pressure from a reg and compliance perspective. We see that as investment, in terms of protecting the future of the firm. But what we do see is that that represents, probably for the next – certainly the next few quarters – probably a significant number of quarters, a higher cost efficiency ratio than the mid-50s.

So following your logic and normalising that out, I would see for the third quarter a cost efficiency ratio just over the 58% mark, and I think that, you know, we're going to continuously give you line of sight for whether its fines, penalties, regulatory settlements. You will have line of sight to those items as well as PPI and the like.

The other point I would make on balancing this is that in the first 9 months of this year, we've generated sustainable saves just under the $900 million mark. Just over $300 million of that was generated in the third quarter of this year. There remains a very strong focus within the firm on cost management, and generating saves to the P&L that help us deal with some of the headwinds, whether it's inflation, whether it's a continued investment in regulatory compliance and related matters. So that focus is absolutely not dropping off. But recognising some of the pressures that we deal with not so much on the revenue line, but clearly from the costs line. I think we are looking at a slightly higher cost efficiency ratio for the next few quarters.

Chintan Joshi

Thanks. And then on capital. You mentioned the PRA buffer. If I look at the EBA stress test, and even if I was to be more nervous on the UK element, doesn't look like the drawdown of your capital ratio is that large. You've got a 5% buffer against the stress test requirements through capital conservation and GSIB. Do you really think you'll need more than that, looking at the EBA stress test doesn't feel like it? And also a quick update on where the consultation on the LGD for the financial institutions portfolio is. Thanks.

Stuart Gulliver

I think we furiously agree with you. But I'm not sure that that matters.

Iain Mackay

But I do – you know, we did come through, as you saw, the EBA stress test. I think that revealed the capital strength of HSBC and its ability to resist or to its stance on stress. The PRA stress test was obviously calculating it in a different basis, and had a UK variant into it. And until the FPC has finished its deliberations with the PRA, you know, none of us know what the outcome of that is. But I think it would be hopeful that again we would demonstrate resilience to stress testing.

I think the element that we would help when we learn more from the PRA, is what the PRA buffer means. I think that is – that's enormously important. It would seem to be focused on idiosyncratic risk, and the PRA's assessment of that risk for each institution. So we'll get some insight on that as they work through the consultation. I believe it will now be January before we actually see anything on that front. Hopefully, by the time we're talking to you at the end of February about the full year results we'll know a little bit more in that respect. And I would love to think that, if not by the end of the year, certainly by the time we do the first quarter results, we'll have greater insight on that front.

Chintan Joshi

And a good quote on the LGD Consultation on Financial Institutions portfolio?

Iain Mackay

Well, I think certainly as far as LGD floors and the financial institutions, that is already in place in our portfolio. So there's not, per se, a consultation that has been completed. There has been an LGD floor applied to FIG exposures, and I think that went in the first quarter of this year, I think it was.

Chintan Joshi

I thought that was on sovereigns, but I can take that offline.

Stuart Gulliver

Sovereigns was last year. Sovereigns was June of '13, sovereigns outside the EEA, which added about 33 billion to our WA's because of waiting 45% LGD on China and Japan and the USA.

Chintan Joshi

Understood. Okay. Right, thank you.

Iain Mackay

If I misspeak on that timing, we'll correct. But I'm pretty certain that we'd got our FIG LGD, which came in definitely in the first half.

Chintan Joshi

Okay. It's just that one your peers was talking about that coming through in the future, so just checking. Alright, thank you.

John-Paul Crutchley, UBS

Morning all. J-P here. Two quick ones if I can. The first was actually just on the associates' contribution and BoCom. Something which I had some expectation would have diminished into the first quarter from what we're talking about in terms of the profit contribution versus carrying value earlier in the year. I just wondered if you can update us on where we're standing on that – whether we can now actually expect that contribution to continue for the rest of the year, or whether that's something which will fall out later.

And then secondly I just wonder if we can get a bit more colour on two aspects of the impairment charges. LatAm – I know you highlighted some aspects of it, but it's obviously still a large proportion of the overall Group charge, you know, probably larger than you normally expect, and just when we can expect some normalisation there. And secondly, the net release in the US, is that's something we can expect to continue? Or was it a bit of a one-off quarter? Thank you.

Iain Mackay

So on BoCom, I think – and bore you to tears and refer you back to our half-year and year end statements. You know, we continue to assess the performance of BoCom on a Value in Use basis against the carrying value of our investment, and to boil it down to the simple realities, BoCom – the performance of BoCom during this year has been somewhat better than expectations that means, from a Value in Use perspective, it continues to perform ahead of where we are from a carrying value standpoint. So, until that crossover point is reached – hoping, of course, that it never is – but until that crossover point is reached, we'll continue to recognise our share of the increase in the net asset value of our investment in BoCom.

Looking beyond that to loan impairment charges. Dealing first with the net release in the US, that is largely a reflection of the continued improvement of the performance of the portfolio overall. I would not expect to see recoveries coming through on a quarter-by-quarter basis against that portfolio. We reassess real estate values on a regular basis, and obviously monitor delinquencies on a very regular basis, and we have seen a reduced charge coming through the P&L on a monthly basis, over the course of this quarter. But that correction, that recovery, is probably a reflection of an assessment in the asset values and the overall quality of the book. But it's not something that we'd expect to sustain.

From a LatAm perspective, I think the main factor to realise in terms of the reduction is, as you will recall, in the third quarter of last year we had a significant charge which reflected a reassessment of our modeling in terms of dealing with restructured loans within, principally, the Brazilian but also the Mexican portfolios. And, having made that correction in the third quarter, that was not a recurring item. So the charge that we've seen coming through, I think it is fair to say is more a reflection of the performance of the underlying assets, although as commented there was a single charge coming through Global Banking and Markets this quarter in Brazil, which knocks it up. But by the same token we had a lower charge this quarter in Mexico as it related to home builders.

John-Paul Crutchley

Thank you very much. Cheers.

Iain Mackay

Thank you very much. Next please.

Chirantan Barua, Sanford Bernstein

Good morning folks, just have two questions, one on household risk weights. Iain, in the past I've been amazed at the three times kind of risk density on the book, and now, with the results that you have in the quarter, when are those models up for re-validation? How long do you have to carry it at kind of three times the exposure? That is number one on household. And the second is if you could, Stuart, just give an update on the Hong Kong situation, with the headline political risk, and how it has gone into retail and commercial loan volumes and risk appetite for you?

Stuart Gulliver

Yes, sure.

Iain Mackay

So on – Chira, great question on risk-weighted assets. We actually introduced, over the course of last year and early this year the benefit of what we call Gen2 models in the US, which was the re-basing of those models. However, there are a number of restrictions in terms of how we are required to model that run-off portfolio. One, we are dealing with downturn LGDs, so when you reflect the lowest point from a Loss Given Default perspective, that is pretty much locked into the modeling, and similarly downturn PDs. So what moves down the overall risk-weighted assets, in absolute terms, in the US is the reduction of the exposure at default. Which means running down the portfolio.

In terms of the concentration of RWAs, in reality that is not going to change significantly while we have this portfolio in the books. So today we still have a risk-weighed assets density of about three times the net book value that sits on the balance sheet. That will not change for the foreseeable future unless there is a change in attitude of our regulators on both sides of the Atlantic, as it relates to how those are to be modeled from an RWA perspective.

We're sitting with assets of about $25 billion in the US, and we continue to carry risk-weighted assets of about $75 billion.

Chirantan Barua

So Iain, just a quick one on that, If I were not a bank and I were to buy out that portfolio now, would my risk-weighted assets again be ratified at exactly the same historical LGBs and PGs? That would mean these guys would never get any lending.

Iain Mackay

To be clear, most of the buyers of the small tranches we are selling are not banks. They are specialised investors in the US, which might broadly be categorised as hedge funds, but they are specialised in this case in terms of distressed residential property. I could not possibly comment on what their capital requirements are and how they are risk-weighted. I do not know

Chirantan Barua

Is the bottleneck from the US or the UK regulator?

Iain Mackay

It is from both sides of the Atlantic.

Stuart Gulliver

On Hong Kong, so far there has been very limited impact on our business. If you take it at two or three different levels, in wholesale banking there has definitely been some delays of IPOs and bond issues, not because the market could not digest them, but more that the issuers are pausing and waiting to see whether sentiment might improve. I would not say that there have been failed transactions, at all. As you know, the equity index is broadly unchanged and has not sold off as a result of what has been taking place.

This is not in the first three quarters' numbers, but we have seen a little softness in our RBWM business, where activity is a little bit slower – and I mean a little bit slower. There is a little less activity in wealth management and a little less activity in credit card sales. In the Commercial Banking spaces, those businesses that are in the areas affected are obviously affected, but those areas are fairly limited in terms of their geographic space.

The Bank has one branch that has been closed for most of the time. That branch and its ATMs have been out of action. That is our Mong Kok branch, which is a significant branch in Hong Kong. The Mong Kok protests on Argyle Street and Nathan Road are actually at the junction on which our branch sits. What we did – and this is a great tribute to our staff in Hong Kong – is moved all of the trade processing. Our trade factory for Asia, or Hong Kong and China anyway, sits in that operation. That was relocated to the backup centres in the new territories. The staff worked tirelessly over the 1 October long weekend to ensure that there was very little interruption to any of our customers. We are still at 100% capacity, but operating from the new territories. The impact on our business so far has been very limited.

In terms of the broader question of what this says to us about Hong Kong, this is not exaggerating to make a point, but we have been here for 150 years next year and Hong Kong has been through much tougher times than this. It has prevailed and emerged stronger in all previous challenges, and I am sure that will be the case this time. The important thing, which we will all look at carefully, is the rule of law and the extent to which it is preserved. So far, it does appear to have been honoured and preserved here, although that is the aspect on which we most need to focus. It is a tense situation but, in terms of our results, it has not had a significant impact so far.

Manus Costello, Autonomous

I wanted to thank you for the clarity in the way you are presenting your results, these days. That was a complex quarter in terms of one-offs but, because of the way you now present it, it is much clearer for analysts and investors to study, so thank you very much for those changes.

Relating back to your strategy update last year, 2013, can I check on some targets? You talked about having a cost/income ratio target in the mid-50s then. When you talk about it being in the higher 50s now for a few quarters, are you walking away from that mid-50s by 2016? How protracted is that period of it being in the upper 50s?

Secondly, in terms of the capital allocation of the group, at that time your guidance was implying that capital banking would grow as the proportion of capital allocated, which indeed it has. At the same time, GB&MGB&M was to go backwards, but actually GB&MGB&M is slightly higher as a proportion of overall capital allocated now than it was then, and retail is lower than you were anticipating. Is that shift away from retail into GB&M something we should expect to continue? It is quite striking, when we look at loan growth, how strong GB&M is relative to retail.

Stuart Gulliver

On the cost/efficiency ratio, the cost of global standards, of compliance and regulation are going to be higher for a period of time. Therefore, we are starting to walk away from the mid-50s for the 2016 number, because we can see ahead a continuous need to keep tightening up standards. We can also see an almost inevitable raft of further conduct and charges to come. We think it is going to be in the high 50s, to be honest with you. The change in cost of running a global bank has become more acute in the last 18 months to two years, from when we were actually doing that work.

I will let Iain talk in more detail on the RWA change. Yes, we have deliberately built up our Commercial Banking business, but a lot of the RWA change in Global Banking and Markets is involuntary. Much of it is related to change in RWA density brought about by regulators and not because we have changed our decisions about any particular business. A lot of it reflects that. RBWM has done more disposals than any other business, so we have exited a lot of RBWM businesses and, therefore, effectively got rid of quite a lot of RWA assets from within RBWM. CMB remains as we said, GB&M is more involuntary and RBWM does not reflect a lack of focus on the business at all. There will be some exchange rate movements through RBWM as well.

Manus Costello

Just to follow up on the capital point briefly, they may be involuntary, and I can see how there are going to be more involuntary changes coming through over the next couple of years with the review of the trading book, but the net effect for shareholders is still that more of the capital is allocated towards GB&M. Are you saying you are happy, when we have a strategy refresh in 12-24 months time, that it shows GB&M to continue to be a large proportion of the business?

Stuart Gulliver

GB&M's RWAs have actually fallen by 5% during the course of this year. The first quarter was 553; the second, 537; the third, 527. We have actually brought them down by 5% during the course of the year, by conscious action to offset the RWA density increase.

Secondly, what we actually forecast at that investor day was that we expected GB&M to be about 30-40% of the P&L of the group; CMB would be 30-40%; and RBWM would be about 20-30%. That has not changed. At no point did we indicate that we were exiting GB&M.

Iain Mackay

To be clear on Stuart's point, Manus, notwithstanding that there have been involuntarily increases through regulation, and the business most significantly impacted by that is GB&M, throughout, the GB&M team under Samir have been focused, and continue to be focused, on working down RWAs. There has been a very concerted and ongoing effort to manage that business model more efficiently and, within that, manage down RWA concentration. The capital allocations we talked about remain consistent, but as you would have expected some of the regulatory change challenges how that business is conducted, the concentration and return on some of the capital within it.

If I boil it down, in the CMB business, RWAs are growing as we grow credit and lending in that business. GB&M continues to focus on actions to manage down RWAs' intensity, which has risen principally as a consequence of regulation. As Stuart mentioned, the significant repositioning of the RBWM business clearly has created some downward pressure on the capital invested in that business, but it is not an articulation of a change, risk appetite or intention, from an investment standpoint.

Stuart Gulliver

There is one other point to emphasise on RBWM. If your argument is that RBWM has higher returns and, therefore, we should be investing all of our capital, you need to dig one level below. Put aside conduct risk. About 80% of RBWM comes from two locations. I do not think it is a strategy to build the group out on two locations. Hong Kong and the UK account for 80-85% of RBWM. Remember, we are only a full-service bank in two locations. It does not make sense, even though RBWM has very high returns, to exit anything else and put everything on two locations.

Martin Leitgeb, Goldman Sachs

This is in regard to CCAR in the US, where submissions are due in a couple of weeks. Could you update us on your thoughts there? Do you plan to upstream that dividend or look at alternative ways of shifting assets into the US in order to utilise capital there?

Iain Mackay

The next submission to the Federal Reserve is due in early January. There is no real testing and assessment against the mid-term submission by the Fed. It was completed in July; the next assessment is in January. As I think you probably hear from all of our US counterparts, the team is singularly focused on making the necessary improvements to pass CCAR at our next submission.

In terms of capital constraints, we have always been clear that the surplus capital sitting in the US business is likely to be trapped there until we can see our way through substantially completing our obligations under the preferred prosecution agreement. In the meantime, equally so, where there is an opportunity to put more assets in the US business, for which there must be a clear US provenance or purpose for using the US balance sheet, then we will take those opportunities, as and when they arise. That is how we continue to focus on capital management in the US. We know there is a surplus there, but it is highly improbable that we will be able to dividend-out any part of that until we make significantly greater progress against DPA requirements. In the meantime, we will focus on growing that business and utilising the capital within that balance sheet as effectively as we can.

Raul Sinha, JPMorgan

To circle back on costs, I was wondering if you might be able to give us an indication or estimate of the dollar amount, in billions, of additional compliance-related spend that you might be thinking of budgeting, which is obviously causing you to give us this new shift in the cost/income ratio guidance. Related to that, how much of this would be a revenue cost? Presumably that is not captured on the line on risk and compliance that we can see in the P&L?

On PPI, I was wondering if you could discuss the provision charge you have taken in the quarter, which is higher than the usual charges you had taken in this area. Have you seen a spike in claims? Can you tell us if this is driven by a reopening of already-settled claims or is this something you have seen from the claims management company?

Iain Mackay

If you look at the chart on page 9 of the slide deck, we have gone some way to separate the costs that cover risk, compliance and related items, and the impact of them on a year-to-date basis. It is not insignificant. Just as we are not inclined to provide a percentage rate of increase from a revenue perspective, it would be unwise to provide a percentage rate of increase from a risk and compliance perspective. You could also draw on Stuart's comment that, when you look just at the increase in headcount in the compliance space over the course of the last few years, and the rate of that beginning to slow, further investment in this area is required. We have not finished the agenda for regulatory change quite yet. It is difficult to predict. There is obviously a very sharp focus on managing this as carefully as we can. I hope that the details we have provided give you some sense of the contribution to increasing costs from risk on compliance.

Stuart Gulliver

The revenue foregone or exited is in the past. That is part of the revenue headwinds that we faced over the last couple of years. What you cannot and nobody can factor in is what revenue we might have made in a different world, hypothetically – I don't think you need to factor that in your model. We have completed most of the business exist we have done, so therefore I do not think there are future revenue headwinds from global standards. There are cost headwinds. There is not even an opportunity foregone, because these are clearly not the types of people with whom we want to do business.

Iain Mackay

Going back to PPI, I do not know if you tracked back to when we had made PPI provisions historically, but this is the most significant step-up that we have made for the better part of a year. It is purely a reflection of the inbound claims that we see. A significant majority of those are sourced by claim management companies. What we had evidenced over the last three or four quarters was a declining trend of inbound claims from our customers, which we had either approached directly for remediation or in fact they had made contact with us. What we most definitely saw in the third quarter of this year was renewal of the efforts made by the claims management companies to generate interest around PPI. That resulted in inbound claims. Our approach to provisioning has always been informed by the number of inbound claims, and how we then deal with and manage them. That is the factor. In our experience, it is largely driven by a renewed vigour from the claims management companies.

Raul Sinha

Have claims continued at that level into the fourth quarter?

Iain Mackay

We would expect to see the level at which we evidenced it in the third quarter to remain fairly stable for the next couple of quarters.

Ronit Ghose, Citi

Stuart, can I follow up your comments on the cost/income ratio? You comments about the increased cost of doing business for a global bank make sense. I am wondering what the translation of that is in RoE terms. In the old days, we were used to RoE being in the mid-teens, and then being in the low-teens, like 12% rather than 15%. Will 'mid-teens' really be more like a 10% RoE going forward, for a big global bank like yourself or your peers?

Stuart Gulliver

Such as Citibank, for example?

Ronit Ghose

Exactly, you name it, or JPMorgan or whatever.

My second question is that last week the BOJ moved into another round of QE. How does that impact your business, if at all, particularly in Asia?

Stuart Gulliver

QE from Japan has tended to go into countries where Japan's supply chain is. Japanese QE tends to be much more directive than American. American QE went around the world with zero-cost dollars and inflated emerging markets throughout the world. Japanese QE seems to go very specifically into Asia-Pacific, where the Japanese supply chain is. It helps Malaysia, Indonesia, Thailand and the Philippines in particular. To some extent, it provides those economies with quite a push, which more than offsets any slowing that might take place from China. We are a second-order beneficiary, in the sense that it should support some of the ASEAN countries' economies.

On the RoE point, we have to work through this in the sense that, when we finally know our core equity tier one, we can then give some decent thought to what our cost of equity is then work out, using a classic Stern Stewart, what return on equity creates value for you all as shareholders. There are a couple of missing parts to all of this. When we set the 12-15 target, we had assumed, and actually we were quite open about this, it was off a 10% core equity Tier-1 we are now at 11.4%. So funnily enough, we are not doing 12-15 off 11.4 if we were thinking about doing 12 off 10. So therefore to be honest with you, we will get a better idea, probably the first quarter next year, because hopefully we will have clarity in core equity tier one. We will have a bit of a better feel for what our cost of equity is.

Again, if we assume that Miller-Modigliani actually works for banks, our cost of equity should be lower than it was in 2007, given how much more equity we are actually holding. Then from that we can assume what is a return that delivers the classic Stern Stewart value added. And yes, to answer your question, yes, it is going to be lower than 12%.

Ronit Ghose

Okay, thanks for that, it's really helpful. Can I just ask one very quick follow-up? I'm on slide nine, which is a really useful slide. Is it possible for you to, when you've given us the drivers, the risk compliance, $700 million year on year, is it possible for you to give us a base number for that?

Stuart Gulliver

It's not at hand here.

Ronit Ghose

Okay, don't worry, I'll follow up later. Thank you very much.

Stuart Gulliver

Thank you. Next one, please.

Mike Trippitt, Numis

Good morning. I had just one question, but if I could just follow up on Ronit's question, which is an obvious sort of follow-on from your cost point, Stuart. I completely understand what you are saying about the gearing of the business, but just in terms of pretax return on risk assets, presumably given that you're talking about costs that does have an impact on those targets as well, I don't want to draw you into an updating on strategy at this point, but do you have any sense of pretax return on risk assets and the sensitivities around the targets that you gave last year?

And the question I had was just I see you've taken a provision on FX. There's a fairly sort of chilling warning in the Outlook Statement that if no resolution is agreed before the term is reached the resolution might actually involve the payment of a significant financial penalty. I don't know if you could just enlarge on that? I don't know what you can say in addition to those comments on FX.

Iain Mackay

On return on risk-weighted assets, we can sit down and go through and understand the performance of the business with and without significant items and underlying bases, and it sort of gives you a sense as to the overall profitability of the business. But when you come back to looking at return on equity and return on risk-weighted assets, it is the harsh reality of the mathematics that significant items, to the tune of 2.2 billion adversely affect the return in risk-weighted assets of the firm.

However, when you look at the targets that are set for each of the Global Businesses by the markets in which they operate, they continue to be measured against return on risk-weighted assets which triangulate us off a higher equity number to be able to achieve returns in equity in excess of the cost of our equity. So we continue to challenge the businesses in terms of achieving returns on risk-weighted assets, which depending on the Global Business, tend to vary between 2.2 and 2.6 return on risk-weighted assets. The significant items which we have flowing through the Income Statement this quarter clearly, and that's most notable in Global Banking and Markets, clearly adversely impact the return on risk-weighted assets that are realised. It doesn't detract from the targets that they are pricing to on a daily basis.

Mike Trippitt

Okay, so you're still sticking to that 2.2-2.6 range at the moment anyway.

Iain Mackay

Yes.

Stuart Gulliver

Sorry, Mike, could you repeat the other question, because your line is really garbled, about FX?

Mike Trippitt

Sorry, I apologise. On FX I see you've taken a provision of 378, which you've a statement in the Outlook around a payment of a significant financial penalty if resolution is not reached.

Stuart Gulliver

That's just referring to that; so what we have said is, 'Look, the FCA is the 378, but that is only the FCA.' And I think what the wording is trying to say is, 'We have not actually reached a formal agreement with the FCA, but to lead you to expect that the 378, although it's a provision, will be the number.'

But the thing to also bear in mind is this is not an omnibus settlement, so there are likely to be other regulatory bodies or judicial bodies that may well also be seeking penalties for the same thing.

Mike Trippitt

Okay, over and above the 378. Okay, fine.

Stuart Gulliver

Okay, but that is the FCA one.

Tom Rayner, Exane

Good morning, everyone. Iain, can I just go back first to the Bank of Communications question? Can you tell us what the value-in-use is at end of Q3 versus the carrying value? I think headroom is there for 500.

Iain Mackay

500.

Tom Rayner

Yes, but can you tell us what the numbers are?

Iain Mackay

No.

Tom Rayner

Well, the headroom was less than 500 at the half-year. I'm assuming that that headroom is now virtually zero unless you've increased the value-in-use again.

Iain Mackay

No, as I mentioned earlier in the call, BoCom has actually performed quite well. And if in fact we have any headroom it has remained consistent or slightly improved.

Tom Rayner

So the DCF has just unwound as you would expect, without any change to assumptions. I guess I'm asking because it makes it impossible to forecast this line if we don't know what's going on between those two numbers.

Iain Mackay

Well I'm sorry, Tom, but we can't forecast that line either because it's largely predicated in the performance of BoCom. We are a minority holder in BoCom and we get access to market information about BoCom pretty much at the same time as everybody else in the marketplace does.

Tom Rayner

Okay, so you wouldn't be able to tell me what the 3Q headroom was even if you had the information.

Stuart Gulliver

No, Iain cannot tell any more than you can.

Tom Rayner

Okay, all right. Thanks.

Iain Mackay

I wish I could because I'd quite like to be able to predict it as well, but I'm afraid this is an assessment that we do every quarter. We update it; there are a number of assumptions that fit into that model. Broadly speaking, our assumptions on broad economic indicators and discount factors remain quite consistent, and the main variable is the performance of BoCom and their capital strength.

Tom Rayner

Right, okay. Can I ask you then just on the revenue guidance; you're obviously quite reluctant to give a forecast on revenue. It looks to me like clean of everything that revenue is possibly growing between 3% and 4% year-on-year, which starts to feel okay. I wonder if you could maybe talk maybe more specifically on net interest income because volumes annualising 5% or 6% now, and margins were stable in the third quarter. You talked a lot last time about rate sensitivity. Obviously a few things have changed since then. I just wondered if you could update us on your thoughts on NII rather than revenue.

Iain Mackay

I think overall from a net interest income perspective, overall from a Group perspective, and I think I mentioned earlier in the call that broadly speaking our margins had remained fairly stable from the beginning of the year. They're certainly down when compared to last year, but fairly stable since the beginning of the year. One adverse impact in net interest income are the Consumer Credit Act items, which we've made reference to both this quarter and the earlier quarter, and that is a net interest income. It's an interest income line item which adjusts for that. But broadly speaking, we do see progress in net interest income on a quarter-over-quarter basis, so I think in that stand it's a fairly stable outlook.

Again, hence the comments coming from balance sheet growth that Stuart referred to earlier. As we continue to grow the balance sheet with a reasonably stable net interest margin prospect, hopefully that will translate through to improving net interest income.

Tom Rayner

Okay, thanks. And just one final one, if I can, on TLAC, because I understand on a deposit funded institution issuing obviously then a lot more sub-debt, I guess, or senior out of the holding company becomes more of an issue than if you're less deposit funded. But your point on multiple point of entry, I mean HSBC has a holding company obviously at Group, and I'd just like to understand a bit better why what's being proposed wouldn't simply mean just moving everything to that holding company. Is it because of the way you're subsidiarised across your Global businesses? I'd just like to understand why that second aspect might be an issue for you if it's a multiple point of entry.

Iain Mackay

Tom, I don't really want to speculate on what the guys come out with at Brisbane. There is a document that was out there which was broadly leaked, presumably to try and get some insight about how market participants felt about it, and obviously to get some insight as to how various national regulators felt about it, and it probably succeeded in that outcome.

What that translates into in terms of a final proposal, I don't know, but what we have been led to believe is that there'll be a detailed QIS and consultation period following November. How that then translates into a final recommendation around having to put in place bail-in-able instruments, I think we're a long way from having real clarity around this. Where we've been clear is that our Bank, and you've followed us for a long time, Tom, and you know that whether it's a subsidiary or whether a branch, we fund locally from the local deposit base. We generally carry a surplus of deposits to loans within the vast majority of the organisations around the world, and we would draw reference to the fact that where we carry surplus deposits it would tend to indicate a certain inefficiency in the funding model of having to go out and issue debt.

When you think about where our major debt assurances sit, it sits in the US, where the CML run-off book is core self-funded, and as that book runs down: guess what? The funding requirement for that book goes with it. The other debt assurance has principally been in the US and the European market, and has principally been in support of either regulatory requirements or funding to support certain activities through the Global Banking and Markets Business.

So again, we will certainly respond to any consultation on TLAC, and that response will be a reflection of our business model.

Tom Rayner

Okay. All right, lovely. Thanks a lot.

Iain Mackay

Thanks Tom.

Stuart Gulliver

We've got time for one last one.

Jason Napier, Deutsche Bank

Good evening. Just the one question then, and it goes to slide nine, which is extremely helpful, and a repeat of a similar version at the half-year. If we look at the components of operating cost growth by type and then by global business, it just looks like RBWM saw a pretty meaningful uptick in quarterly cost inflation. I guess you commented earlier, and we would expect to hear that Risk, Compliance and Global standards are primarily a GB&M issue. Clearly the return on risk-weighted assets is attractive in that business already, but I wonder whether you wouldn't mind perhaps talking about what might be driving

RBWM and costs, and whether there is a difference in trajectory for those; whether we should expect costs to continue to grow in the fashion just reported. Thank you.

Stuart Gulliver

No, Jason, a lot of the compliance costs actually sit in RBWM, because a very big part of the conduct risk agenda actually sits in RBWM. That's where the PPI sits; that's where the Consumer Credit Act in the UK sits. There's a chunk of it, and also what we've done as well to try and get ahead of any future conduct risk issues, and you're probably aware of this, at the beginning of 13 we removed product based commission structures and went to a general bonus scheme. That had some negative impact on sales revenues initially, which are now being built back up. And then at the beginning of 2014 we also removed specific commissions on selling things like credit cards and mortgages; again, replace them with a broad base balance scorecard. And again, revenues there are being built back up.

We have also gone through a kind of fair pricing exercise in retail banking to make sure that what we're charging people is fair and reasonable. So for example, in the UK we've changed the way we charge for unauthorised overdrafts, and that also informs why, and you can look in the actual IMS number; you'll see the personal lending line is down. That's basically UK overdraft charges coming out. It's actually UK overdraft charges and actually a cap on lending rates in Turkey inform those two specific things.

So there's quite a big chunk of conduct risk, and therefore, if you like, Compliance and Risk related costs sitting in RBWM as well.

Iain Mackay

There's a couple of specifics in there this quarter as well, Jason. The FSCS levy that I mentioned, $111 million, that sits squarely within Retail Bank Wealth Management within the UK. Inflation key driver across LatAm, principally Brazil and Argentina, and then some of our Asian markets. And then exactly the points that Stuart commented on, we obviously have several million customers in Retail Banking and Wealth Management, and we have the same know your customer obligations as we do across any other customer base in the firm. So just as we experience that in Commercial Bank, Global Banking and Markets and Private Bank, so we also experience the need to ensure that we've got consistent standards within the Retail Bank.

Stuart Gulliver

It's a great business, it's got great returns. It's dominated by Hong Kong and the UK, but it actually does have exactly the same financial crime and conduct risk obligations of the other businesses.

Jason Napier

And just to be clear, I think in an earlier question you confirmed that Risk, Compliance and Global Standards, that is just expenses rather than revenues forgone.

Stuart Gulliver

That means forgone, if you like, within the Global Businesses.

Jason Napier

Yes, okay. Thank you.

Stuart Gulliver

Okay, that concludes today's call. Thank you very much for joining us. Thank you. Thank you, operator. That brings the call to an end.