Edited Transcript

Post-Annual Results 2015

Meeting with Analysts hosted by Iain Mackay, Group Finance Director

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Corporate participants:

Iain Mackay, Group Finance Director
Russell Picot, Group Chief Accounting Officer
Jane Leach, Head of Group Regulatory Reporting

HSBC

Alastair Ryan, Bank of America

On impairments, just go through again – an interesting one – how forward-looking you're able to be in making impairments now. You commented on oil and gas; you've made a collective – we're mindful that IFRS 9 looms in the distance, so you've got a framework for thinking there. How would you characterise your provisioning against energy and commodities at this point?

Then just a secondary on commercial real estate lending: I have read the annual report and I couldn't find the breakdown of the Grade 1-7 loan-to-values. You might have buried that in one of the supplementary documents, but it strikes me that that commercial real estate portfolio should be very low-risk, how you've designed it, but I just haven't found the numbers to get that comfort yet. That might be my fault. Thank you.

Iain Mackay

On oil and gas, let me step back. From our perspective, when we look at the policy with respect to wholesale provisioning, we look at a nine-month emergence period. A loss event, before that loss becomes evident and apparent in terms of actual distress – that's probably not exactly the right way to describe it – within an individual borrower, let's count that as nine months. When we look on a name-by-name basis across oil and gas, which is what the team's done, over the second half of 2015, then assumed a $30-per-barrel price for the next two years; then we look at our nine-month emergence period and built the provision based on an application of the accounting policy that we've got, so nine months emergent, and the loss event, the trigger being a $30-per-barrel oil price. Then we look across on a name-by-name basis, which is a piece of work that will continue reviewing name by name, but going through name by name across each of the jurisdictions in which there's a significant oil and gas exposure. Then we're looking at the financial strength, the capability, the quality of the collateral, whether it's reserve-based lending, which sector it falls into, if it's a service company, if it's an integrated producer, if it's a pure producer. Then that is informing a view about the collective provision that we take, and that collective provision was then recorded. You probably don't care a great deal, but it was recorded in the legal entities where those exposures, on a name-by-name basis, are booked. It's not that our portfolios are identical in any size, shape or form, but what was informative was that, when we looked at what the American banks had done in the oil and gas space, it seems, based on their disclosures, to have been similar in approach and, on a proportional basis, similar in magnitude. That's how we dealt with oil and gas.

In addition to that, what the team has done is then looked at say, okay, let's say the price per barrel of oil went lower than $30. For the sake of argument, pick $25 or pick $20 and stay there for two year, with the same emergence period. What would that represent in terms of incremental losses to the portfolio, which we then use for internal stress-testing? Now, does that give us perfect insight as to what is going to happen in the next 9, 12 or 24 months? No, it doesn't, but we think it gives us a fairly prudent basis for provisioning.

For metals and mining, we have undertaken a review by sub-segment and by country. Thus far management has not witnessed significant losses or credit deterioration that would suggest the need for an impairment overlay based on extended price expectations at year end 2015. As you saw, the provisioning that we took for the whole of 2015 in metals and mining was of 100 million against our exposure. Overall, we're fairly confident of the quality of the book of the business, with less than 2% impaired in both metals and mining, and in oil and gas. Equally, as I'm sure you can imagine and should expect, the level of heightened surveillance and scrutiny being applied to the book as a whole – not just oil and gas, but metals and mining – but a view that the risks of the credit cycle turning are significant sat at the top of emerging risks for us now, for the last six months. The increased level of scrutiny from Chief Risk Officer Marc Moses and team is fairly intense.

In terms of LTVs and the credit rating, Russell, do you happen to…?

Russell Picot

Page 139, Alastair.

Alastair Ryan

That gives us the LTVs on the lower-grade book.

Iain Mackay

The 9-10 are impaired, so you're looking for the higher-grade book.

Alastair Ryan

Yes, because that's what the market's been worrying about, if there's a shock in various markets.

Iain Mackay

It wasn't a particularly numerical chart, per se, but if you go to the chart on page 8 in the deck, the purpose for laying that out was to give a sense of the degree of diversification within the portfolio overall. When you look at the commercial real estate component of this book of business, it's not a particularly large proportion of the overall balance sheet. In fact, it's a very small proportion of the overall balance sheet. The Hong Kong and UK portfolios are very conservatively constructed portfolios. They are portfolios based on prior experience, which are stressed on a regular basis. By 'stressed', I mean we run stress tests on the portfolio and there is a propensity within this sector, across the three main exposures – which are US, UK and Hong Kong – to, as and when needed, restructure the portfolio in terms of assuring the obligor has the ability to meet its cash flows.

Not at our instruction but informed more by market practice, an example of that in Hong Kong, over the course certainly of 2015 and the latter part of 2014 is that, as commercial leases are coming up for renewal, they are being renewed. They're being renewed at lower levels, but they're being renewed at levels that certainly and more than adequately continue to provide very robust cover for debt servicing for the obligor in each case. That is encouraging the rational behaviour that's going on, and that's particularly in the high end across Hong Kong as we observe it, but also on mainland China, where the obligor is a Hong Kong parent company.

Russell Picot

Can I just add on IFRS 9, Alastair? You asked the relative comparison. Obviously the oil and gas exposure provisions are an incurred basis, as opposed to expected credit loss basis. There's actually quite a useful description in the document about our IFRS project, following the work of EDTF. On page 351, you'll see there's a very short paragraph of stage 1 that directly compares IAS 39 collective impairments with a broadly similar approach under IFRS 9. Obviously IFRS 9 has got a completely different basis to trigger, based on increasing credit risk, but that first stage provision, if you like, is based on a 12-month expected credit loss under IFRS 9, as opposed to what Iain's described as a broadly 9-month incurred inherent loss under IAS 39. That's quite a useful description.

Iain Mackay

There are five good pages describing IFRS 9 in there.

Raul Sinha, JPMorgan

I just wanted to follow up on that discussion with a couple of follow-ups and then one broader one. On oil and gas, can you tell us if you've got any US shale exposure?

Iain Mackay

Our direct exposures to shale producers are immaterial Let me be clearer on that. We've got greater indirect exposure to the service companies that have got exposure to US shale, but what I can say is that, within the service company space, recognising that they are the most susceptible to significant and harsh downturns in the oil price, we've seen that in actions taken by the Halliburtons, the Schlumbergers, the Smith Internationals and so on. There are a lot of small service companies that we have steered well clear of, but through the large service companies that is where the exposure sits, with respect to US shale oil.

Raul Sinha

The second one is probably one for Russell on the undrawn commitments to oil and gas. On page 441, you've got this big 665 billion total commitments number.

Iain Mackay

That includes committed and uncommitted lines across the entire book.

Raul Sinha

The third one is just on BoCom. We've already had this discussion, so I'm not going to repeat the whole thing, but I just wanted to check with you when the next evaluation of the accounting method will be.

Iain Mackay

We look at it every quarter. The challenge on this one for us is more about the accrual around the carrying value. As they continue to generate profits, we pick up an after-tax 19.03% of it. Dividends are a reduction to the carrying value, but their dividend payout is at a very low level, which is one of the challenges around this investment for us. Their dividends just are nowhere close to the profits we accrue, so carrying value continues to build, so it's more a question of carrying value getting ahead of value in use. Now, there are clearly things that could impact value in use coming down, but we look at it every single quarter. The Hong Kong team gets the opportunity obviously to look at market indicators as well as the data coming in from BoCom. The data from BoCom is dealt with a quarter in arrears, but to the timing of their publication. Then we take a little bit of time and sit down with the BoCom finance team and go through where we are, in terms of some of the assumptions as well. The assumptions are derived from market-available information.

Martin Leitgeb, Goldman Sachs

First, Hong Kong retail profit ability: obviously in the first quarter we saw a drop in fee income, which bounced back in the fourth quarter. I'm just wondering if you could steer us a little bit on how we should think of profitability there evolving the next 12-24 months, to the extent possible, in terms of what we see in the mortgage market – higher rates and provisioning still at a very low level. Is that a new run rate of what we see, at least for the time being?

The second question was on the US CCAR. Obviously having passed last year, could you give us any sense of dividend payout you would envisage this time around, to the extent that you can comment? Would there be, if anything, something very nominal at this stage or could it be more meaningful upstream?

Iain Mackay

Let me take the second one first. We do not expect, and have planned accordingly, to see a dividend from the US until 2018. Let me just walk through the rationale for that. We have three consent decrees in place with the OCC and those are consent decrees in which good progress has been made in addressing them. One is the Bank Secrecy Act, which addresses anti-money-laundering matters. The other is to do with foreclosures and the other is to do with overall profitability of the organisation.

Our expectation is that we'll deal with all three or we'll conclude dealing with all three in the course of 2016, but certainly one of them towards the end of 2016, and expect to get OCC concurrence that they have been dealt with in 2017. Our expectation is that the likelihood of us being able to persuade the Federal Reserve that they would allow a dividend to be paid is unlikely, until we've addressed those consent decrees. Addressing those would result in a re-rating by the OCC of the overall standing, from a safety and stability perspective, of the US bank and that creates good groundwork for us to be able at least to propose dividends within the capital plan that would be submitted as part of CCAR. I don't think that would be done in 2016, but we would, assuming that we got those matters addressed, address it in 2017.

The other factor that's to be considered in there is that the manner in which the Federal Reserve treats the runoff closed-down portfolio of sub-prime mortgages absorbs a lot of our surplus capital in the US through the stress test. The continued focus on accelerating the rundown of the sub-prime portfolio means that the amount of theoretical capital that can be consumed by the stress test diminishes over time as well, and that more closely aligns a PRA-informed view and a Federal-Reserve-informed view as to the surplus capital that sits in the US.

Those actions sit within the nine strategic actions that we're focused on and that we talked about last June, in terms of rebuilding profitability in NAFTA, addressing global standards globally, but there's an aspect of this that's quite specific to improving the dividend prospects from the US business. The third obviously is continuing to be successful in passing CCAR.

In Hong Kong, the levels that we're seeing for the first quarter are consistent with levels that we saw not in the first quarter of 2015, but in the first quarter of 2014. The significant pickup that we saw in brokerage revenues in the first half of last year, for obvious reasons, is not recurring. The underlying income from the deposits, the current accounts, the saving accounts and the ongoing turn within the insurance business around investment products is consistent, but the effect of any of the brokerage pickup in revenues that we saw in the first half of last year has reverted to what you might call pre-Hong Kong/Shanghai Stock Connect normal levels.

Manus Costello, Autonomous Research

When do you think you'll be able to give an indication of the IFRS 9 impact? I'm just interested in the timing. I know you've given us a description, but we're all obviously interested in some numbers, I guess both with your HSBC and your EDTF hat on. I'd be interested to know when you think banks are going to be able to start telling us more about that.

Secondly about a couple of the geographies, Canada and Saudi: it looked like Canada had a weaker second half. I'm guessing that was to do with the energy impairments, but Saudi seemed fine. Between them, they're actually a reasonable proportion of the group profits now. Could you give us some kind of outlook, because they're obviously both energy-exposed areas?

Russell Picot

On numbers, there is quite an interest in shape of numbers, Manus. The European Banking Authority has gone out with a survey to be completed broadly in the middle of this year. I think that's quite ambitious actually to expect all the European banks, given what we know about their own project status, to have actually resolved all the methodology questions, got their systems up and running, and something operational. I suspect there'll be some very broad shape.

What we're saying is, when we think we've got reliable estimates, then we'll share them with you. You're quite right that will be dealt with by my successor. I think the expectation is that that's going to have to be some time during 2017. The question is whether that will be during the year or towards the latter part of the year. IFRS 9 is a very significant change to loan impairment methodologies. It's very technical, it's very data-intense and the banks need enough time to work their way through that. I suspect, like many banks, we'll be able to give an indication of shape before we start giving the sort of granular analysis. There's obviously quite a high hurdle we have to clear to put the numbers out in the public domain for them to not be numbers we would wish to recant later on. That shape that, by the end of 2017, you're going to have to have given indications of what the numbers look like, you'll probably see some numbers starting to emerge through 2017. I personally would be surprised to see many banks, if any, putting good quality numbers out at the end of 2016.

Iain Mackay

Through the European CFO network, which meets two or three times a year, this is high up the agenda. It would seem that there's really nobody, within that population of Europe's 22 largest banks, who is particularly confident. Everybody's obviously working on it at different stages of development, but I would say, absolutely in line with Russell's comments, there's nobody, as far as I can discern, who's particularly confident about numbers, based on where they're modelling. This is all about building out models and validating those models. Until you can populate them and test them, people are going to be reticent about putting out numbers with high degrees of confidence until well into next year.

Russell Picot

There's also a familiar question around this. The first time you actually get numbers out in the system, they're going to be very unfamiliar. Management's going to want to spend some time understanding those and then running a further set based on some different economic scenarios, so we can start to get a much better feel for what drives the big numbers.

Iain Mackay

Canada: tougher second half, certainly informed principally by higher loan impairment charges. Canada, as I'm sure you know, Manus, has significant exposure to oil and gas, and natural resources overall. Low oil prices are weighing on the Canadian economy. The main feature of what we saw was coming through loan impairment charges and adjustments to policy rates by the Central Bank of Canada. There was lower net interest income, as the rate was adjusted down. Again, this is a bank on which we sit with a very healthy loans-to-deposits ratio. The lower interest rate environment hit the net interest income and loan impairment charges was the other main feature that came through.

Talking to our Canadian colleagues, they expect 2016 to be quite a difficult year, informed principally by the low interest rate environment. Again, there are very high levels of scrutiny around the quality of the book. Outside the US, Canada was the entity that most significantly impacted by the provisioning that we did in the second half of the year around oil and gas. Overall, I think we've got a fairly good balance in that portfolio. Although we certainly expect slightly lower levels of profitability in Canada in 2016, it's going to be informed largely by lower net interest income.

Saudi again is a 40% associate for us. Again, it's a very well diversified book of business. Loan impairment charges coming though Saudi have been negligible in 2015, certainly absolutely consistent with recent history. In terms of the level of exposure, we've got exposure there to the large integrated oil companies, so Saudi Aramco, for example. There's a bit of a natural hedge there that, when you see the upstream activities and downstream activities, they tend to have a reasonably offsetting effect, not absolutely, but there's a hedging effect that protects them from the most extreme aspects of downside, which you see in larger organisations like BP and Shell as well.

Overall, the outlook for Middle East and North Africa as a whole, for 2016, for us is positive. We have a team there that is, notwithstanding the difficulties around oil and gas, encouraged by what they see in the environment there. There is a lot of refinancing activity going on. In a refinancing space, this works quite well for us with names that we know well. I was out there a few weeks ago and the team there is cautiously optimistic about the outlook for 2016.

Chintan Joshi, Nomura

To be clear, Iain, you say you've looked at two years of $30 oil, and Russell said that oil and gas provisions are on an incurred basis rather than expected loss basis. What have you covered yourself for? Have you covered yourself for two years of $30 oil?

Iain Mackay

No, we've modelled it out for two years and then taken what we would expect to occur within the next 12 months.

Chintan Joshi

Is that double what we have or actually should it be more, because the curve can't be linear?

Iain Mackay

Yes.

Chintan Joshi

Moving on to the questions I had asked on the call, where I was hoping to get some visibility, I want to get to revenue and cost PBTs in 2015. I just want to look at it ex-disposals. What would the run rate have been in 2015?

Iain Mackay

If you took 2015, ex-Brazil, ex-CML, ex-legacy credit, it would be 53 billion.

Chintan Joshi

Cost and PBT, do you have it?

Iain Mackay

No.

Chintan Joshi

The FX headwind that we are seeing, in 2015, is on the average.

Iain Mackay

In 2015, we saw over 4 billion, nearly 5 billion, of FX impact on revenue.

Chintan Joshi

That was 2015 average versus 2014 average.

Iain Mackay

Yes.

Chintan Joshi

I'm interested in 2015 average versus spot or year-end, or something that guides on the headwind. I suspect it is a couple of billion on the revenue line, but it's hard to understand that.

Iain Mackay

The main currency that's taken a hit since the beginning of the year is sterling against the US dollar, so think about it in the context of our sterling block, which is basically the UK economy right now. I haven't got those numbers in front of me.

David Lock, Deutsche Bank

Just to follow up on the split of revenues and another one on minorities, what proportion of your cost base is in sterling? If you don't have that number, maybe we can get it later. Given the moves we've had recently, how much costs do you have sitting here in London?

The second question was on minority costs. I note that below the line, double below the line as you disclose in the interims and the annuals, you had about 860 million for Tier 1 grandfathered and eligible CRD IV securities. What's the run rate of the full impact of that? I think you've issued some additional securities that haven't paid a coupon yet.

Iain Mackay

Are you talking about TLAC?

David Lock

AT1, so CRD IV eligible securities. I think you issued one that hadn't paid a coupon last year, which will be paying one this year. I just wanted to check what the run rate cost of that was.

Iain Mackay

I don't know. I don't have those numbers in front of me.

Russell Picot

It will be in the notes. We'll dig you out the note number.

Andrew Coombs, Citi

Perhaps you could comment on the *FT* article that ran the other day, with respect to the computation of the bank levy based on the HoldCo viability. I'd be interested in your thoughts on that.

The second question would just be on the GB&M RWA reduction plan. You've done 70 billion of the 135 to 140, including a big chunk from the legacy credit book. Given the market environment, should we anticipate that that either will slow slightly in the first half of this year, or alternatively would you expect to recognise a larger loss as you run down some of those positions?

Iain Mackay

On the first point on the *FT* article, it was not news to us. It's nice that the *FT* reads the fine print; it's a pity they do it three months after everybody else. No, we absolutely knew about that and that was factored into our calculations. The downside scenario was factored into our planning process for through to 2021 actually, assuming the Government follows through on its undertakings to change the basis of the calculation. Certainly based on our estimations of TLAC requirements and how that TLAC would be provisioned, we factored the downside scenario into our planning cycle, so it was absolutely not news to us.

In terms of GB&M RWAs, the more we get into this, the more we see opportunity from a capital efficiency/capital allocation perspective. The 72-74 that we issued is a good start. It was good progress from the teams and there's a great deal more to do. I'm very confident about hitting those numbers and possibly more, but that more is more likely to deal with, for example, though we are no longer selling Turkey, we have not adjusted our RWA reduction target to take account of that. The rebasing of the RWA target really only takes account of foreign exchange impact. The 275 continues to assume that we will hit the 290 and that incorporated the disposal of Turkey, so we will cover that off.

One of the other areas that represents some risk, but again we're focused on trying to mitigate that as much as possible, is a Fundamental Review of the Trading Book. Again, we're not deep enough into that in terms of understanding exactly how that will be applied to provide precise numbers about the impact of that on the portfolio. Certainly if we're successful in getting each of our desks qualified from an IMA perspective, then the impact is probably fairly muted and, assuming that it is, one of the things that Samir and the team are focused on is mitigating that through further RWA reductions. Certainly in terms of progress around legacy disposals and legacy runoff, the estimation of the impact on income of disposing of legacy remains consistent with the guidance we provided in June.

Andrew Coombs

I guess the follow-up would be: of the 14 billion reduction that you've had in the legacy portfolio, how much of that is due to asset sales versus how much is due to natural attrition, compression and so forth?

Iain Mackay

The majority is asset sale.

Tom Rayner, Exane BNP Paribas

Can I ask you and maybe Russell as well why, at this stage, it's so difficult to give an indication of at least the magnitude of IFRS 9? I guess the same goes for some of the other issues around Basel IV as well, because you have to, as a management team, have some idea when you're setting your dividend policy for instance what these pressures are going to be. I wonder why you can't give us a little bit more, maybe not the exact number, but at least a sort of ballpark figure on how material you think these issues might be to your capital position.

I have a broader question on the regulatory environment overall. We keep hearing from various UK bank managements that the Bank of England is fairly happy with the amount of capital that's going to be offset to any future pressures. I'm just wondering what your view on that is because, when I look down the capital stack, quite a lot of these things are hardwired in. It's hard to see, apart from Pillar 2A where you might be able to have a reduction to offset some of the other pressures, where the regulators are going to find this forbearance, if that's the right word, unless we're going to start cancelling whole projects that have been through consultation, QIS (Quantitative Impact Studies), etc. I'm just interested to know what your views are, more on an industry level than stock-specific. Thank you.

Russell Picot

In order to calculate numbers, we need to build all our IFRS models. We need to source all the data. We need to be able to connect those models to our underlying data and then run it through the system, and we need to be able to do that with reasonable certainty about what accounting judgments there are. There are still ongoing discussions between the industry and the IASB about some quite important technical matters. We are still building our models and we're still sourcing and cleaning our data. Until we've actually effectively completed all of those steps, then we're not going to be in a position to get an end-to-end run of all of our portfolios and come up with numbers.

The question also links into what you do with the number when it emerges. Now, clearly there is a regulatory capital question that is then raised. At the moment, there is this regulatory adjustment for expected loss. The Basel Committee has said they will review that, as a matter of principle, in an expected-loss world. They cannot begin that work until the US Federal Accounting Standards, or FASB, has actually come up with its own version of expected loss that may be expected in the coming weeks. When the US sends the FASB standards out, then the Basel Committee will start a piece of principal work around whether or not they would take the accounting numbers, with or without adjustments to regulatory capital. That's the series of steps or sequencing that we need to get through before numbers will emerge.

Tom Rayner

I understand that. When the board is making their decision about whether to pay 70-80% of earnings out in dividends, they're going to have to have some fairly clear idea that, whatever the exact answer, IFRS 9, alongside a few other issues, is not going to completely force that decision into reversal in 12 months' time. I'm just wondering if it's the case that you can't give the number to the market until you know the exact number or can we assume that you kind of roughly know and that's fed into the whole process, so when these decisions are being made they're not being done completely in the dark?

Iain Mackay

We don't roughly know, but we also know the strength of our capital resources and our distributable profits, Tom. Broadly speaking, the magnitude of IFRS 9 is not going to have a significant effect in terms of propensity in that regard.

Tom Rayner

It's not just this issue. I'm just thinking on other issues as well, like all of the Basel IV.

Iain Mackay

To go to Basel IV, as it's called – and Jane will jump in here – what the PRA has said to us is similar to I imagine what you have heard from other UK banks. They see our capital, as targeted by us, in the 12-13% range as absolutely appropriate. When we then broach the topics of a review of the standardised, a Fundamental Review of the Trading Book and operational risk, the answer that we very clearly get is that, to the extent that there are higher capital requirements imposed through changes that might be the so-called Basel IV, which of course the Governor strongly contests and doesn't actually exist, they would be offset by adjustments to Pillar 2A and not necessarily the PRA buffer, but could be influenced through the PRA buffer as well. When you think of that, that represents for us over a Common Equity Tier 1 over 100 basis points of capital for us. To broadly put that into capital terms, that's about 10 billion of capital. There are adjustment mechanisms that they say they are going to use.

Now, being slightly sceptical, I'll believe it when I see it, but that's what very senior people in the Bank of England and the PRA are saying to us. They believe that the revisions that will be finalised by the Basel Committee will deal with some of the inconsistencies that they see, in terms of the application of either internal ratings-based models or the standardised approach. When those inconsistencies are addressed, then they would be confident in reducing the capital requirement through Pillar 2A, which is there specifically to deal with risks that should be captured in Pillar 1, but are not captured adequately, and certain other risks.

The question here is how long it takes for the Basel Committee to work through finalisation of where they've got pretty close and a Fundamental Review of the Trading Book. They still seem to be quite a long way away on the standardised and there's still a lot of work to be done from an operational risk perspective.

As ever, our point back to them is, 'Well, could you please hurry up and get on with it, so that we can actually get clarity around whether 12-13% is the right space?' We think it is, based on everything that we read and everything we hear back from them. That's a very confident view expressed by senior regulators, but it would be good of them to finish this off and, as it were, lock it down.

Tom Rayner

I totally agree. On your 12-13%, what sort of management buffer over the MDA is that assuming? Is that 1-1.5?

Iain Mackay

We said 1-2% of management buffer.

Jane Leach

It might be worth adding on the Basel IV front and credit risk in particular that one of the big elements of that is the credit risk standardised approach. If you think back over last year, last summer we were talking about going completely away from having external ratings within that. There's been a very large change in the approach to that and there's still a long way to go to finalise that.

Tom Rayner

Did they cancel that whole idea?

Jane Leach

They've completely changed the whole approach now, so they've now put back in external ratings, but with an option to do an approach not using external ratings. If we were to build in their first draft into defined planning, it would not really be the right approach to take, because these things are changing so quickly. We need to take an assessment and keep it live over time. Bear that in mind.

Chintan Joshi

Can I ask on dividends, the calculation that you do, I presume at the level where all the resources are freed up and then you decide that is paid out, in 2015, what was the dividend that you declared versus the resources that you had available? That's just to give us some comfort on the future.

Iain Mackay

Our dividend is informed by the profitability of the group, not in any given single year, but also across the prospective view, but also the capital resources of the group. The ability to support that, from a cash perspective, is informed by the dividend flow from the subsidiaries to the holding company, which made a mockery of the *FT* article about us possibly basing our headquarters in United States, because you couldn't flow dividends back to the United States without them being taxed at 32%, which would have been interesting.

The practice we adopt across all of the subsidiaries is a payout ratio of 50-70% from the subsidiaries, on an annual basis, to the parent company. Subsidiaries that cannot do so, because of their profitability, are focused on improving their profitability, which goes back to the NAFTA action item within the nine strategic actions, because our two most significant subsidiaries that will remain part of the group, at least for the foreseeable future, are the US and Mexico. Mexico is paying a very small dividend, but it's just not sufficient. That's informed by the fact that their overall levels of profitability are not sufficient, so we're clearly focused on making sure the Mexican team can meet their local regulatory requirements with a small management buffer. Consequently that informs the dividend that they can pay to us.

That policy is applied to Hong Kong, to the UK and to everybody, and then that informs the cash resources, so internal dividend flow supporting external dividend flow. To the extent there's a shortfall in any given year, again it's informed by going back and looking at the prospects of that business, the regulatory environment for each of the subsidiaries in terms of what might some of the limitations be between now and 2019, as they move through to implementing local regulatory requirements in terms of meeting Basel III, and then adapting where we are based on that outlook.

Chintan Joshi

Is it fair to say that, for 2015, the 51 cents that you declared was actually the subsidiary dividends that flew into the group?

Iain Mackay

There was a very slight shortfall against that based on 2015.

Russell Picot

Iain, can I go back to one question you asked about AT1s? We issued in September a €1 billion-dominated security with a 6% coupon, and there's no dividend yet paid on that. It pays every six months, so the first payment will be March this year.

Iain Mackay

To be clear, from a planning perspective, we factor in the cost of debt issued, not whether it's paid or not paid a coupon, at this point. That's also informed what we've done from a planning perspective through to 2020, as it relates to TLAC. As TLAC builds, then we've informed the cost that we would need in each year, based on the TLAC that we would have issued up to that point or TLAC that we would issue during that year.

David Lock

If we could have that on a quarterly basis, because it's only split out in the annual and the interim that we get the disclosure of that on a diluted basis? The cost is in the annual accounts.

Iain Mackay

I don't see any reason we can't provide that. If they've lost weeks of their life, we might not provide this. There'll be a cost/benefit around it.

Robert Sage, Natixis

You mentioned that Mexico was still quite difficult. It seems you made a loss in the second half of the year. Could you give a high-level reason for that? It looks to be loan impairment charges, but could you confirm that?

Secondly, in the US, there was quite a significant increase in past due but not impaired. I'm assuming that's oil and gas, but again could you just confirm that.

The third question was that there's quite a lot of prominence given to this new JV in mainland China to do with nationally licensed securities. Is that something that's really of strategic importance, more than any short-term numbers' significance there?

Iain Mackay

Yes, it's strategic importance. That will not have a significant impact on our numbers over the course of the next three years. First of all, it has to be approved. It has been at a provincial level; it needs to be approved at Beijing level. We would have an expectation that that approval would be received some time during the course of 2016. With it being majority-owned and mainland-China-authorised, it allows us to participate in the capital markets in China fully, which certainly in terms of underwriting and supporting local debt issuance has not been something we've been able to participate in up to this point. This is strategic. This is not something that's going to have an impact on revenues in the next four to eight quarters, by any significant degree. That being said, there is strategic investment being made to ensure that, on receipt of approvals, we're able to start operationalising that.

From a Mexico perspective, the main driver on second-half profitability was a strengthening in loan impairment charges. That was influenced by a very small degree by oil and gas but, by a greater degree, by higher provisions across a number of industries, including the strengthening of provisions against already impaired facilities. What was your question on the US again?

Robert Sage

It was really looking at the past due but not impaired. The numbers went up. I'm assuming it's oil and gas, but I was just wondering.

Iain Mackay

That's informed only in very small part by the oil and gas sector. The increase in US past due but not impaired was largely in the 0-29 days bucket. This is a volatile metric as it can be affected by timings of public holidays and other short term logistical issues for our customers. The 0-29 days past due observed at year end did not roll over into the longer run buckets, and it is therefore not of concern.

Chris Manners, Morgan Stanley

Could I just ask you to maybe give a little bit more on the outlook for Hong Kong? What do you think we should be pencilling in for loan growth? What about margin expectations? Obviously HIBOR's gone up, but US rates may be pushed out a little bit.

The second one is on the capital stack. I guess, if we add up all the bits that we know – the 4.5 of Pillar 1, the 1.3 of Pillar 2A, a capital conservation buffer of 2.5, a countercyclical buffer of 0.2 at the moment and 2.5 of GSIB – that gets you to 11. Then you've got your 1-2% management buffer you talk about, which gets you to 12-13. As these pieces move, are we going to see that management buffer change? The way I'm thinking about is that your countercyclical buffer, because of what's happening in Hong Kong and because of what's happening in the UK, is going to increase unless you decrease your 1-2% management buffer. Presumably your 12-13 may go up a little bit.

The last point was just on the tax rate. Obviously we've got the 8% profit surcharge. I know that you had a 20% effective tax rate last year and you say it's going to go up. What should we be pencilling in for the group?

Iain Mackay

We do expect a higher effective tax rate informed by the 8% surcharge, but that's the extent to which we'd expect it to increase. We'd probably see something between 23% and 24%. Jane, do you want to do the capital stack question and I'll tackle Hong Kong?

Jane Leach

When we try to identify how much of a management buffer we need to hold, part of that is the consideration of the movement of the regulatory buffer. Yes, you do expect those regulatory buffers to change over time, not because CRD IV is particularly evolving, but just because they are movable over time. The Pillar 2A will move. The countercyclical buffer, as you said, will move and that is taken into account when we've decided that 1-2 is an appropriate level to hold the management buffer at. It incorporates an element of uncertainty within those buffers.

Chris Manners

If they move the buffers, you will move the management buffer.

Iain Mackay

We might. It depends. A buffer is a buffer. You need to deal with being in a regulatory capital environment and obviously the environment we're dealing with, but it's not going to be mechanistic in terms of 'Right, the countercyclical buffer's moved 0.1%; we're going to move the management buffer 0.1%.' That's what it's there for, Chris, but what it's obviously going to be informed by is, one, what we see happening on the regulatory front and what we see coming through the profitability of our businesses and the capital strength of the group overall, as well as the individual subsidiaries within the group. Part of it's played by what we see in front of us and part of it's grounded in the fact that we maintain a reasonably strong buffer against unforeseen eventualities coming through operations.

In Hong Kong, for the first couple of months of the year, Commercial Banking and Retail Banking and Wealth Management performed very much in line with our expectations. That's actually true pretty much across the piece, not just in Hong Kong. Global Markets, within Global Banking and Markets, has been slower and debt capital markets just look at the level of issuance across the globe, particularly that from banks. It's down significantly, so our DCM team is seeing lower levels of activity in the first couple of months of the year than we otherwise would have anticipated, but the main revenue headwinds that we see are within the Global Markets business and that is true within Europe, as it is within Hong Kong. The Commercial Banking and Retail Banking and Wealth Management businesses are performing largely as we'd expect.

Tom Rayner

Just a follow-up on what you've said there about the management buffer, surely you have to keep it as a fairly fixed amount above whatever the point of automatic restrictions is. It's going to be determined, is it not, by the bond market and the AT1 market, more than the interplay of where you may have regulatory buffers today, because we haven't fully transitioned or we haven't seen the full countercyclical buffer yet put in place? When we get to that point, surely the management buffer has to be what is demanded by the markets. Is that not the case or am I misinterpreting that?

Iain Mackay

What's going to be demanded by the markets is based on the market's view of the fundamental credit-worthiness of this organisation. When you look at the strength of the balance sheet, whether from a liquidity perspective, a capital perspective, a conservative underwriting approach, a conservative risk appetite overall, Tom, informs fundamental underwriting. If I was sitting on the fixed income side, from an investor's perspective, I'd be looking at the fundamental credit-worthiness of the organisation. Right? The AT1 market just looks utterly dislocated right now. Is that informed by market dynamics or is it informed by the fundamental credit quality underwriting exercise that's gone on? You have to suspect it's a little bit of both when you look at those that are particularly in stress but, from our standpoint, maintain strong ratings; maintain a strong balance sheet; have adequate capital resources. There's a fine balance to be struck between adequate capital resources and over-capitalised.

Tom Rayner

If I put it a different way though, depending on where the level is, and I'm not saying that I know for sure where the level is, but wherever it settles down there's always going to be some volatility in your capital ratio, maybe coming through from pension deficit movements or whatever. It's not just about AT1, is it? If you do breach that MDA level, you can't pay ordinary dividends. There are other things that you won't be able to do, so a management team cannot run more, I would argue, than maybe 11-2% away from that level. Whatever that level is going to be what falls out of this. I don't know how that management buffer could suddenly go to zero, because we're at a good level. Do you see what I mean?

Iain Mackay

You're the only person who's mentioned zero, Tom. We've never suggested that. We think the management buffer sits at 1-2% and, when we've got information about where the final capital requirements are, then we can inform. Stable is an interesting point, because there are time-varying elements within that, but it can't be mechanistic. No, we're not going to sit with a zero buffer and there's never been a suggestion that we would sit with a zero buffer. We've said it's going to be between 1% and 2%. That represents significant cover and, by the way, we've got pension surpluses, not deficits.

Russell Picot

It's also fair to say, Tom, that as you see regulatory landscapes changing, then what management does is to understand the sensitivity of capital ratios to economic changes. Clearly standardised credit risk portfolios are less sensitive than modelled one. Part of the management team book of work is then to understand the Basel Committee/PRA changes to the capital regime and see what they do in terms of increased or reduced sensitivity to your capital ratios. All of that goes into the management mix, in terms of how we think about these things.

Iain Mackay

Again, there are other elements around this. We've got a set of actions that we set out last June that are informed by the headwinds that the group is dealing with. Regulation has changed the capital efficiency of some of the businesses within the group and the capital needs to come out of those businesses and be reallocated to businesses that meet or exceed the hurdle rates for profitability in the group. That's a process that is underway.

We also happen to be an environment that is informed by our risk appetite. The reinvestment of that is presently progressing at a rate slower that is slower than we ideally would like, but what then translates into is a higher capital position within the group, which I'm sure is reassuring to regulators and to bondholders, and hopefully would be reassuring to equity investors as well. All of the actions that we set out in 2015 were informed by the headwinds that we saw then, as well as some of the headwinds that we anticipated. One of them was clearly the need to improve the efficiency of the capital allocated to businesses. Whether it's the reduction of risk-weighted assets, which is an important piece of work that goes across all the businesses, most importantly Global Banking and Markets; the need to improve the profitability of the number of the underperforming subsidiaries, whether on a standalone basis or when informed by their contribution to the propensity to pay group dividends, that's why we set out those nine actions.

By the same token, there are subsidiary elements to those actions that are coming up every two weeks, when we sit down with Stuart to go through every single one of those actions. We get the team that's focused on each of those around the table. What's the progress we're making? What's coming out of the work that we're doing? What are we learning more about? Are there opportunities that we didn't realise existed in the middle of 2015, which we now need to deliver against? Are there further risks emerging that we need to address? When those risks emerge, what are the actions that we can take, either in further reshaping the group or addressing further reallocation of capital requirements within the group?

It's not a static process. Again, an interesting aspect of this is the stress-testing process with regulators. We'll sit down and we take, literally every day of the week, management mitigating actions as they represent risk to capital, as they represent risk to the overall strength of the balance sheet of the group. When we then sit down and have a stress-testing exercise with the PRA and list out all the actions that we have taken over the previous year, two years, three years, four years, interestingly, the regulatory stance on that is that those are not management mitigating actions. They don't count. They're not the big sell stuff or reshape the group. Actually, they are management mitigating actions and you need to take them every day of the week.

We have a clear view about where our capital needs to be. It needs to be between 12% and 13%, frankly the higher end of that range, based on everything that we know today. That's where we're going to progress over the next six months or the next 12 months. If at some point regulation informs us that we need to be above the top end of that range, which it absolutely has not at this point, then we'll progress there. That's kind of what we have to do.

Alastair Ryan

You've got the market in the room, so you'd probably expect this, but I come at it completely the opposite way from Chris and Tom. Since last summer, there is no Basel IV. They couldn't be clearer: there is no Basel IV. The Bank of England sat us all down in a room and said Pillar 2 is going to broadly materialise into Pillar 1, and then they called us all back into a room and said, 'I don't think you've been paying attention. We're telling you that,' as you've said they've reflected to you. The PRA is radically more stable now than it was, from your point of view, and Basel's more stable. Basel's also said that FRTB's landed at a lower number on average than it might have done and they've committed not to increase the capital requirements of the industry as a whole. Wouldn't that argue the other way around, that you should be cutting your target capital ratio, because you've got a lot more clarity on where you need to be? I think that Basel IV is a very backward-looking debate now, because the people who didn't implement it said they're not going to do and the PRA has told you they've changed.

Iain Mackay

That's an interesting theory. I think it's divorced from reality. The revisions to the standardised approach are proceeding. Whatever the Governor of the Bank of England says, those revisions are proceeding. We're still doing QISs; Basel's still working on it. On FRTB, there is still work to be done. Op risk, there is still work to be done. It's kind of an interesting catchy headline, 'There is no Basel IV,' and God bless us I hope there's not a Basel IV, but there are refinements to Basel II and Basel III, Basel II principally, which are ongoing and are not finalised. Am I inaccurate there?

Jane Leach

Whether you call it Basel IV or not, it's still going to happen.

Russell Picot

There are also UK financial system statements, Alastair, as you well understand, and not bank-specific statements. You could listen to that, and I've played this back in a whimsical moment, and say, 'Of course that means, by definition, that you will not seek to impose higher capital burdens on the banks.' You will simply immunise any rise in provisions, which impact capital. I'm not sure that's what we meant.

Iain Mackay

Just to be clear – well, I don't know if we can be clear actually – the PRA has been really helpful in saying, 'To the extent there are capital increases coming through standardised and the Fundamental Review of the Trading Book,' then their stated policy view, at least in a room with us, is 'we think that offsets to some degree, whether it's entirely or partially, in Pillar 2A.' That was new to us in the fourth quarter of last year as well. That's helpful, but it was also stated at a system level as a whole, as opposed to a bank-by-bank basis.

Again from our standpoint, let's demonstrate the ability to generate capital from operations, strengthen capital resources through a more efficient allocation of capital and management actions that are associated with that, and demonstrate that we can do that. Stay very engaged around the Basel debate, which is informed not just by Basel but how the EBA gets in the middle of it, how the PRA gets in the middle of it and how others get in the middle of this. Then stay very closely engaged with the PRA around how they intend to implement that and how that then informs where we end up from a Pillar 2A perspective. There are changes but, at least from the PRA's perspective, their policy intention would be, to some degree, offset any increase in risk-weighted assets by a reduction in the rate requirement.

Jane Leach

There's also some quite helpful signalling around timing as well, which was really helpful. A lot of us, it's understood, have a way to go yet before it's finalised. It is out there as 2018-19 and, in addition, they've said, to pick up your point on the countercyclical buffer, it's absolutely understood that that could move. Clearly it wouldn't whack up to top level unless the global economy's really going some, so you'd expect to be putting on capital at a rate at that point. Actually, they've also signalled that an increase in the countercyclical buffer would be announced earlier, so we'd essentially have a year's notice that that was going to be happening. All these things are really helpful in terms of our ability to be able to manage our capital, going forward.

Iain Mackay

I'd love to revise down the numbers, Alastair, but it might be a while before that happens, if in fact it ever happens.

James Chappell, Berenberg Bank

What I wanted to get your thoughts on is if the payout ratio is becoming increasingly meaningless. Your capital generation and your accounting profits are becoming divorced from each other if you take BoCom. You've got an accounting loss to come through that's a non-capital item. People sort of focus on payout ratios; is that becoming increasingly meaningless for banks, because of what's happening in terms of capital in the background, the rules changing and how you plan?

Iain Mackay

I wouldn't say it's meaningless, but we set the 40-60% five years ago, when I think we were of the view that we were looking at a fundamentally different investment environment as well. When we work through the process of realising significant RWA reductions and capital released on the back of that, as we've made some pretty reasonable progress in 2015, the reinvestment of that is informed by a risk appetite statement approved by the board. Our reinvestment of that is informed by conservative underwriting standards for our customers. The reinvestment of that is informed by hitting return on capital, return on risk-weighted assets and return on equity targets that we've set for our businesses, by geography, by product line. If they can't price their business with each of their customers across a range of product lines to realise those returns, they won't be reinvesting their capital.

In the view of this management team, there is no point in reinvesting capital that does not meet the thresholds that we've set for achieving a return of equity of the group of greater than 10%. Right? If we assume our cost of equity of between 9% and 10%, we've got to be achieving a return of greater than 10% and, therefore, the business that we write has to triangulate in on achieving that target.

If the market demand for our services does not allow us to do that at the rate at which we would like to do it and, to be clear, we are reinvesting, but we are certainly reinvesting, and that was evident in the fourth quarter, at a slower rate than we would ideally like to be investing, but it's informed by our discipline around the risk appetite statement and the returns we need to achieve. If that period persists for some longer period of time, we could see ourselves sitting on much higher capital ratios, because we've reduced the amount of capital, and at that point sitting at a much higher capital ratio and sitting on capital that is not productive and does not represent a requirement from a regulatory perspective or from a prudent risk management perspective. Then it's the board's view that we should be paying that back to shareholders. In that kind of scenario, a dividend payout ratio of 40-60% is probably not relevant.

If you're sitting in that scenario to be paying out at a higher and possibly, given the regime, a much higher payout ratio is something the board would consider, but it would consider in the round in terms of the profitability of the business, the prospects for profitability of the business, the strength of the balance sheet overall and the regulatory environment we're operating in. Those are the considerations that we'd take. This is not and should not be, in our view, a simple mathematical calculation. Manus, I think, was next.

Manus Costello

Just to follow up on the logical maths of that, what you're effectively saying is, if you can't reinvest, you'll pay out more than 100%. Would you do it through share buybacks or special divvies? It becomes logically impossible to have a progressive dividend if you're paying out of capital freed up from not being reinvested. I mean, at some point, that has to give, right?

Iain Mackay

Yes, there's a point at which you've distributed your excess capital, so you can't go beyond your regulatory requirement and we wouldn't go beyond the regulatory requirement.

Manus Costello

Indeed and, at that point, you've got lower RWAs and a lower revenue-productive balance sheet, and you have to cut the sustainable ordinary dividend.

Iain Mackay

If we find ourselves in those scenarios, then the board would act accordingly. I don't know what's confusing people about the dividend. This is exactly what we've said about the dividend for years. It's what the Chairman said in his statement this year about the dividend. Our intention, our goal, is to pay a progressive dividend. It is informed by the profitability of the group. It is informed by regulation. That's what it's informed by. I don't get the mystery around this. If we have the propensity to do so, and certainly all the management actions that we laid out in June of last year and against which we are making progress and delivering, are to inform and to sustain the ability to build a progressive dividend. What we're not going to do is something that jeopardises the safety and soundness of the group.

Manus Costello

On a separate, but maybe related, point, if I look back to the beginning of 2014, revenue expectations from us lot for this year, for 2016, were 17 billion. We're now talking about an exit run rate of 53 and we were talking about some headwinds. Alright, there's some asset sales in there accepted, but it's a pretty hefty downgrade. From the way that Stuart was talking on the conference call, it sounded like you were somewhat sceptical about your ability to take out further cost. He was talking about such a large programme in place already. Strategically, is there a point at which you would have to say, 'Actually, we're going to deliver returns of 8%, not 10%, for the foreseeable future because of the environment?' or do you think you'd reload and say, 'No, that's not acceptable. We've got to take another 5 billion out,' or whatever it is?

Iain Mackay

You've got a fundamental review of the group. If we assume that our cost of equity is 9-10%, delivering on a sustainable basis return of equity of 8% doesn't sound like a particularly good deal from a shareholder perspective. Unless you simply assume that the industry becomes a utility, which is perhaps where regulation wants to take us, although the regulators would argue that's not where they want to take us, that again becomes an interesting management challenge, in terms of how you restructure and reshape the group to the most capital-efficient parts of that group that can generate returns that support a return above the cost of equity and support a dividend that's commensurate with the overall levels of profitability being generated by the group through the cycle.

When you think about what we've done for five years, Manus, we've transacted 78 times to reduce unprofitable businesses within the group and to reshape the group. We've invested to deal with what we need to deal with as an industry, from a financial crime compliance and regulatory compliance perspective, which is not insignificant. Net of that investment, we've focused on taking a very significant amount of cost out of the group and we continue to do so. We've got 4.5-5 billion to take out between now and the end of 2017. That's what the team's focused on doing.

If, over the course of the coming quarters – and by that I mean through to the end of 2017 – the shape of the industry and the economy doesn't support growth, then it's going to inform us that we need to do more. What we definitively did not say, and I don't think Stuart said last week, is we're not prepared to do more, but we have a timeframe within which we need to evaluate where we stand. We've got to manage the group for the longer term, not based on what happens quarter to quarter, week to week.

Martin Leitgeb

Just a follow-up on capital redeployment: obviously reading the news a number of banks are reconsidering their options with regards to a number of either countries or products globally. In light of your comments earlier about the slightly slower rate of reinvestment of the capital you freed up in GBM, how should we think of your redeployment going forward? Is your risk appetite such that this bit would be mainly organic or could you foresee that there could be an acquisition here or there in order to bolster your market share or your scale, in a certain jurisdiction?

Iain Mackay

It's largely organic. Doing acquisitions consumes a great deal of management time and, with the range of activities that the team is focused on, in terms of delivering against strategic actions, which we think in terms of long-term stability and reliability are hugely important; the regulatory compliance, whether it's on the prudential front or on the conduct front, is a significant consumption of management's time and overall important for the stability of the industry. Continuing to dispose of underperforming businesses or businesses that don't fit the risk appetite of the group takes up a lot of management time. The prospect of taking on an acquisition and making sure that acquisition is properly due diligenced and, if concluded, very quickly and efficiently integrated takes a lot of focus. I think our focus for the foreseeable future is more on organic growth, as opposed to M&A.

Chintan Joshi

Could I touch upon the troubles for Brazil? There are a lot of headlines on regulatory and anti-trust issues. It feels like Bradesco is trying to get out of this by the back door.

Iain Mackay

No, absolutely not.

Chintan Joshi

I just wanted to get your thoughts around the headlines that we've seen.

Iain Mackay

I have seldom met a management team more enthusiastic about getting a deal closed. This is a significant revenue opportunity for them. The interesting aspect is that very little of the networks between HSBC and Bradesco currently overlap, very little. We had just under 900 branches. I can't remember the Bradesco number, but it was 3,000, 3-4,000. There was very little overlap and that goes historically to the home territories where Bradesco is focused and Banistmo was focused. They were two different banks, in terms of the provinces that they served.

What the Competition Commission doing is what the Competition Commission is required to do, which is to look at possible anti-trust and competitive issues within the Brazilian market. The range of questions that they're putting to both us and Bradesco are absolutely in line with the questions we would expect to be asked and have to answer from a competition review.