Edited Transcript

Post-1Q 2016 Earnings Release

Meeting with Analysts hosted by Iain Mackay, Group Finance Director

06 May 2016

Corporate participants:
Iain Mackay, Group Finance Director
Jane Leach, Group Capital Controller

HSBC

Iain Mackay, Group Finance Director

Good morning, everybody. A summary of results on Tuesday. I think on a relative basis, reasonably happy with them. On an absolute basis, any time the numbers fall short of our expectations and plan, we're never thrilled about that. We're certainly building confidence around delivery against cost actions. On a revenue basis, again, from a relative standpoint it's nice to be in-line or better than our competitors, but it certainly fell behind our expectations for revenues in the first quarter. Hopefully we've been sufficiently clear as to why that was. In terms of where we were ending the quarter on capital, very much as expected, recognising that we saw some increases in risk-weighted assets coming through on the back of market conditions, both related to credit deterioration and market volatility impacting Counterparty Credit Risk and Market Risk. But broadly speaking, satisfied with where we are in terms of capital, particularly in light of capital generation in the first quarter, with more than sufficient coverage for the first interim dividend of 2016.

Clearly, still a great deal to do against our strategic actions. It would always be nice to have a slightly more constructive environment, but the environment is what the environment is, and therefore we will continue to adapt to that environment as conditions require us to do so. But the focus remains very much on delivering against the nine remaining strategic actions that we set out in June of last year. Notwithstanding the operating conditions in which we operate being slightly more challenging than they were in June of last year.

So with that, happy to open to questions.

Raul Sinha, JP Morgan Cazenove

Maybe just going back to the question I asked on the call about the jaws and how you see the jaws trajectory for the Group evolving. If we leave quarterly reporting aside, obviously first half of last year for you was very good in terms of revenues, and unfortunately the environment's not as good this time round, but clearly your cost plans are much more progressed. So should we think about this year as the cost performance is more back-end loaded towards the second half of the year, as some of the improvements or some of the programmes that you're saying are now full speed kick in in the second half of the year?

Iain Mackay

No, I think you need to stick with the guidance that we provided last June on costs. This relates to 2016 and 2017. We've got an investment cycle, particularly around Global Standards. That investment will significantly increase the automation and our ability to screen transactions through the Bank, and progressively reduce the costs in that space – although I don't think we'll ever see the cost in regulatory compliance and financial crime compliance come back to historical levels. But to reduce those costs there's an investment cycle that we've got to complete in that regard through 2016 and the early part of 2017.

So if you'll recall some of the analysis that we provided in June of last year, we indicated a growing investment cycle in that space through 2016, with the apex of that being reached early in 2017, and then see net cost benefits coming through later in 2017. What we're clearly much happier about is we've got traction on the $4.5 billion-$5 billion of costs coming through. We've got all the programmes up and running. We've got the $5 billion identified. We're aiming on exiting 2017 at a run rate consistent with 2014, and we've updated as to what that is, so slightly under $30 billion. But we don't anticipate progression from here to 4Q 2017 as being a steady linear downward trend in operating expenses because of the investment cycle, principally in Global Standards and regulatory compliance.

Raul Sinha

And just to follow up on that, obviously you've seen an improvement in performance in March and April relative to January and February. Has that improvement convinced you that you don't need to do any more on the $4.5 - 5 billion in terms of cost saves?

Iain Mackay

I don't think it's a question of convincing us whether or not we need to do more. It's a question of between now and 2017 whether we could do more. We're taking 15% of the cost base out. The target that we've set for ourselves is bigger than anybody else in the industry. And that's not an excuse; we've got a big cost base to deal with. We've got over 400 programmes up and running. There's a real question around the capacity to actually do more within the timeline. It's not a question of whether we can do more in the longer term. We're absolutely committed to the fact that we've got to drive cost productivity year over year. And that's why positive jaws is a target for us. But to conceive of taking out another $1 billion-$1.5 billion of costs over the next 19 months frankly is a question of capacity and ability to do so with everything that we've got going on.

Raul Sinha

Thanks. I share some of your concerns on AT1 for sure. The point is the alternative to issuing AT1 is a lot more earnings diluted for equity shareholders. And so if you think about what the Bank of England is doing in terms of the stress testing exercise for this year, and how the systemic reference points potentially takes the trigger point above the 7% trigger rate for the AT1, which means that in certain scenarios your AT1 issued might not count for the first pass point in the stress test.

Iain Mackay

I don't think we see a trigger point. Certainly the new trigger point that they set for the stress test is nowhere close to 7%. There's the minimum.

Raul Sinha

I'm referring to the FPC. They're including the G-SIB, which they say requires less intensive actions, but it still implies capital actions. So obviously a full loading of your G-SIB would imply that it would be above 7%.

Iain Mackay

The 7% is a contractual term. The stress test is a stress test. And in the stress test I suppose presumably if the stress test pulls you below 7% then one of the capital actions that you would have would be that your CoCos would be triggered. But clearly from a capital management perspective, what the Group does on a day-to-day basis, notwithstanding stress testing and ensuring that we've got robust capital generation and management buffers above the regulatory minimum, of which we've got robust management buffers at this point in time, even as we accrete up to the fully loaded endpoint Basel III. So the stress test is an interesting exercise which informs risk management. Certainly informs the Bank of England from a risk management perspective. But it's a stress test. It's not a set of realistic conditions that necessarily transpire at any point in time. So I'm not sure, other than the academic interest around whether 7% is the right trigger point from CoCos, I'm not sure what we can do about that, to be honest.

Raul Sinha

I guess the question I'm trying to get at is do you think the stress test might eventually become your binding constraint on capital?

Iain Mackay

Well, it's certainly where CCAR's gone.

Raul Sinha

That's the question then. Do you think the PRA is heading in the same direction?

Iain Mackay

That's an interesting question. Jane.

Jane Leach, Group Capital Controller

We have a number of offsets on stress tests as well. So the way that the PRA set the Group's stress testing capital requirement through the PRA buffer is that they obviously allow an offset for the Capital Conservation buffer and then also some of the Counter-Cyclical buffer. So there are two offsets before you get to our individual capital requirement for the stress test. So I think you have to bear that in mind when looking at our capital requirements and the effects of regulatory stress testing. It's clear we need to take account of stress tests when we're doing our planning on our capital. As Iain said it's an interesting exercise to consider the impact of stress on the plan and how we respond to certain stressed situations.

Iain Mackay

But whether the Bank is aiming for the PRA stress test to become like CCAR, which I think it's reasonable to say that CCAR is the binding constraint for the American institutions that are subject to that analysis, I don't know. I think that's an interesting policy question for Sam Woods when he comes in, or Mark Carney. They've said they're not. The entire approach to stress testing is going to change again next year. So they're going to rebuild the framework, they're going to rebuild the templates, they're going to rebuild the approach to stress testing. What they've introduced this year is a higher threshold, with an upper and lower range within which you've got to hopefully pass those stress tests. If you do keep pushing it upwards, upwards and upwards, inadvertently, perhaps, it does become a binding constraint. But it's certainly not at the moment, and I think based on the construct around 2015 it certainly isn't.

Gurpreet Singh Sahi, Goldman Sachs

Last year, if we look at the cost run rate we saw pretty sizeable pickup in costs, second quarter on the first. Now some of the statements that you're making around regulatory compliance and Global Standards, plus the inflation in the market, now this year might be a bit different from last year, but then how should we think about cost progression from here? Would we see a quarter where you run up to around $8 billion on a quarterly run rate basis?

Iain Mackay

No, I think if you reflect on my response to Raul, that's how I think you should think about cost progression. There were a couple of elements within the first quarter cost base in terms of a credit against bank levy. We experience that every year. You assess the bank levy on 31 December, and then as you refine that calculation and complete the work with HMRC an adjustment of just over $100 million in the first quarter, and clearly we had much lower performance costs in the first quarter on the back of lower revenues in Global Banking and Markets. If we can maintain some of the momentum that we built in March and moving into April in Global Banking and Markets we would expect to see a higher accrual rate in terms of performance, in terms of Group costs. And I think what we usually see in the second quarter as well is the FSCS charge coming through from the Bank of England. But again that's a seasonal piece for the second quarter.

Our focus on cost management is to realise the benefits of the cost saving plans that we have in motion, maintain very tight tactical cost control around the short cycle expenses on a day-to-day operating basis, like travel and living, like consulting expenditures and suchlike, and focus very much on offsetting what we see coming through inflationary pressures. And to a significant degree, but not entirely, offsetting the investments that we're making in Global Standards, regulatory programmes and investments in the business. We've got very significant investment going into each of the global businesses, examples of which, in Retail Banking Wealth Management, for example, is improvement of the digital offering across the global platform, but most notably in the UK, Hong Kong and the United States.

So the investment for the future revenue generating capability of the Bank, as well as the future propensity to generate cost productivity year over year and becoming more efficient, is the focus. But, as I said in response to Raul's question, we've got an investment cycle around global standards and regulatory compliance, which carries us through to the early part of 2017. And those are obligations that we must meet, and we will meet. So I'd recommend a reflection on what we provided in guidance in this respect in June of last year, which will give you a sense as to the profile of investment and global standards more specifically.

Gurpreet Singh Sahi

On the Hong Kong bank, historically we see that it has been around 50% of dividends back to the parent. Now – and this is a follow-up from your Tuesday's comment regarding a question – now, given that capital seems very comfortable level, 13.6% end point, and then there isn't much growth to be had – last year's payout was not close to 50%, it was just below – and then your response on Tuesday was, 'We expect all subsidiaries to make between 50 – 70%'. In the year-end the Group needs more dividends to pay out to the shareholders. Can we have a situation whereby the Hong Kong bank pays more than 70% for a while?

Iain Mackay

The same applies to any subsidiary as it does to the Group. If we don't need capital in the subsidiary then we bring the surplus back to the centre. That's the capital management approach we've had for years. If the Hong Kong bank finds itself with capital surplus to regulatory requirements and more than sufficient capital management buffers, given some protection against volatility within the business model, we would move that surplus to Headquarters.

Alastair Ryan, Bank of America Merrill Lynch

On Global Banking and Markets, you've taken out most of the balance sheet you want to get rid of now - what bits are you making a decent return on, the way that you look at it? I know they're not all completely separate. I'm looking at page 22, the GB&M part – a snapshot would suggest that your Credit business is unlikely to be making attractive returns.

Iain Mackay

It doesn't. The balance sheet generally doesn't make returns today. So where we're making good returns are – not the case in the first quarter in Foreign Exchange - but generally we make a very good return on our Foreign Exchange business, our Equities business, the Capital Financing business, Payments and Cash Management, Securities Services. In a reasonably normal environment we make a good return in Global Trade and Receivables Finance, but in the current interest rate environment, with pricing pressure on that space, with much lower volumes for returns in Global Trade and Receivables Financing, both within Global Banking and Markets, and Commercial Banking, are at lower level than we would expect.

So across those, out of the nine businesses that sit within Samir's space, we're making reasonably good returns. Areas where it's difficult: Credit and Lending, Credit Trading, Rates specifically. Principal Investments, which broadly speaking is to all intents and purposes a run-off business is very, very small, and again the returns on that business tend to be lower. So where there is a significant opportunity to generate fees, that is where we have grown revenue within Samir's business over the last four years. And to be clear, if you go back and do the analysis, we have grown the revenue in Samir's business, and the profit in Samir's business, over the last four years.

Within Markets, Foreign Exchange continues to be a very profitable business for us in any quarter that you can call reasonably normal.

Alastair Ryan

And is there anything you can do about the bits that don't work so well? Are they just a necessary cost of carry, is there more costs restructuring you can do?

Iain Mackay

So if you look at the balance sheet specifically, a large part of what informs the $140 billion of risk weighted assets that we're taking out, of which Samir's got about 60% of that work completed now, it is taking under-performing capital out of that business. Some of it may be reapplied within business lines that are more profitable, or with customers that are more profitable within the Global Banking and Markets space, but the Global Banking and Markets team is continuing to look at the profitability of individual customer relationships, and less of a product view and more of a customer view. We clearly make balance sheet available to our customers, but generally speaking in this environment just deploying balance sheet is not particularly profitable in most markets for us. And therefore the relationship depends on being able to pick up our customers' Foreign Exchange, their Payments and Cash Management, any debt driven business or equity capital financings.

And so the relationship is the view that Samir takes when deciding where to exit unprofitable business. So not necessarily products, but unprofitable client relationships. Our view on something like Rates, for example, though Rates is not, per se, a wildly profitable business, nor necessarily is Credit Trading, the platform on which those products are offered is the same platform in which we manage Treasury. And we manage Treasury at a subsidiary and branch level virtually everywhere in the world. So the incremental cost of running Rates and Credit on a relatively small scale globally is not significant for us.

So unless we were to fundamentally change our approach to Balance Sheet Management or corporate treasury management, and centralise everything, I think it is – unless of course the capital weighting just becomes absolutely untenable, I think it is less likely that we would see ourselves fundamentally exiting Rates or Credit Trading. And they are fairly central components of supporting the customer relationship globally.

Daniel Lasry, Sanford Bernstein

I just had a quick question on the book quality. I know on the call you said a lot had to do with corporate downgrades in the oil and gas books. Can you give us some colour as to how much was corporate downgrades and how much was actually internally decided, and how much you see going forward?

Iain Mackay

I cannot answer the question going forward.

Daniel Lasry

Well, not necessarily going forward, but how do you feel it's been going with all the corporate downgrades we've seen in the US in Q1 and Q2.

Iain Mackay

If there is an issue within our book it's in the oil and gas, and metals and mining space. The rest of the portfolio, there is no underlying sector theme across the geographies beyond oil and gas, and metals and mining. In metals and mining in the fourth quarter of last year there were no loan impairment charges taken. In the first quarter we had two charges, both in Australia. And those charges represented by far the vast majority of the loan impairment charges in Asia in the first quarter. In the US and Canada, and with one name in Europe, that accounted for oil and gas.

So in terms of credit quality within the portfolio, and the impact of downgrades feeding through to how that is then reflected in risk weighted assets, it is principally informed by oil and gas, and metals and mining. There is not an underlying theme across the rest of the portfolios anywhere in the world. The credit quality -- outside those sectors – in Europe remains very stable, both across retail and wholesale. The same is true in the US. The same is true in Mexico. The single outstanding feature of loan impairment charges in the first quarter was Brazil, where total loan impairment charges were over $330 million, which was a third of the total loan impairment charges for the Group. And more than half of that was coming through the retail portfolios. And if you were to look at Itau or Bradesco results you'd see a similar phenomenon coming through on the back of slower economic activity, principally coming through retail banking and business banking within the Brazilian economy. So not that I necessarily take a great deal of comfort from selling Brazil, but our expectation is that when we close that transaction – and we anticipate doing that in the month of June – it will remove one of the pressures that we see coming through the loan impairment charge line.

The other pressures that we see coming through which are of an unusual nature are oil and gas, and metals and mining. More so in oil and gas. I think we've still got a couple of quarters to run before we see the sustainable performance within that portfolio. But that being said, as we assess the portfolio on a name by name basis in the first quarter our view was that the incurred but not reported provision that we took in the fourth quarter was sufficient, and we didn't strengthen that in the first quarter. And the names that we saw – individual assessments again, were the names that we saw some pressure on coming through the fourth quarter.

Manus Costello, Autonomous Research LLP

Are you implying that loan impairment charges will remain high?

Iain Mackay

I don't know. I think having an oil price of $45 helps. We don't have significant exposures to oil sands in Dakota, for example. So when you've seen higher numbers come through some of our American competitors they have a higher proportion of their book exposed to oil sands. We have a very, very small exposure in that space. The breakdown that we provided on page 19, the integrated producers we see as being fairly stable. Our service company exposures are broadly speaking to the large global service companies like Schlumberger, Halliburton, Hughes, and thus far they've performed reasonably well. We would expect greater stress for the smaller service companies, which have perhaps less propensity to withstand a prolonged downturn in the oil price. But broadly speaking what is now happening is we're seeing individual names that we've downgraded from a risk perspective within our own scoring system, and as a consequence of which increased provisions against them. So I'm not going to say they're going to be higher for the next two quarters, I'm simply saying there's still a lot to be worked through in terms of how the oil price impacts the long-term sustainability of some of our customers.

Chris Manners, Morgan Stanley

Two questions if I may, the first one is on Global Standards. Obviously it's a huge work programme, a lot of effort, a lot of investment. Could I just ask you, what do you think the tangible benefits are going to be? Is it some sort of competitive advantage, that people will be more likely to deal with you if they know you have better Global Standards? Just think about the cost-benefit analysis on the gold plating that you're doing.

And the second point was on market share - pretty encouraging. I like your slide 14 where you explain some of the areas where you are taking share. Just thinking about Q1, probably saw a little bit of a flight to quality effect from clients. Also you have some competitors re-trenching. Just maybe you could give us a flavour of where you're trying to press your advantage, and where you think that you've got more opportunities to take share. I'm thinking about in GB&M particularly, but also in the Hong Kong market more broadly.

Iain Mackay

On Global Standards first, we're not gold plating. We're meeting legal requirements that exist globally, informed to a significant extent by US and British standards. But we're applying those standards consistently to all the markets in which we operate. If you are to have access to major clearing markets, notably US dollars, you need to comply with US standards. And therefore complying with US standards only in the US doesn't cut it for a bank that operates through a global network serving global customers across that network. And therefore the investment is significant.

Whether customers necessarily care about how good our Global Standards are versus anybody else's, that is yet to be proven. But I think one clear benefit that we do get is the knowledge about our customers. The KYC and the customer due diligence that is required to ensure that we comply with these standards is at a higher level than most of our competitors. I think you've got to exclude the American banks from that, because many of them – although they're under similar operating conditions as we are in terms of being required to tighten their standards in this respect – are probably further ahead than any non-American player. And in the non-American space, I think frankly ourselves and one or two other European banks have got more to do in this area because they're under specific scrutiny by the US Department of Justice or other US regulators.

But I think a very tangible benefit that we expect to get as we deploy that across the countries in which we operate is much more information and much more knowledge about what our customers do, with whom our customers transact, and from that inform strategies to serve those customers both more effectively and more efficiently. That is our view, and it is in actual fact what we need to realise. With the level of investment that we're doing, part of it is in fact just to protect the franchise, comply with law, be allowed to continue to operate on a global scale and be recognised for being good at what we do. So there's an aspect of restoring the reputation of the Group, which clearly has taken a fairly solid bashing over the last few years for these matters. And the second is that it certainly provides us with a great deal of information about our customers. I think in the short-term, what the customers possibly find slightly irritating is the degree to which we interrogate them about what they do and who they do it with.

On market share, Asia most notably. Middle East is an area where again – nobody really pays much attention to the Middle East, but the Middle East had an absolutely outstanding first quarter. Their ability to work both with multi-nationals as well as governments in terms of how they restructure cashflows, funding mechanisms within some of the economies in Middle East & North Africa, with the change in the oil price, are taking a needed, in our view, much longer-term view as to what they need to do in terms of modernising, if you like, some of the fiscal systems and monetary systems within their countries. And through our Global Banking and Markets team they're well positioned to do so.

Anecdotally, I was in Abu Dhabi and Dubai in early February, and spent some time with Mohammad Al Tuwaijri (CEO Middle East and North Africa) and my opening gambit was, 'This is going to be a pretty tough year for you' and Mohammad was like, 'No, this is brilliant. This is a great environment for us'. It's probably going to be a little bit tough in the Retail Bank space, and we've seen that in the first quarter where we saw slightly higher loan impairment charges. We saw that in the fourth quarter also, where non-nationals, if they find themselves in the position that they can't pay their bills they run the risk of getting slammed in jail. And therefore if they get in the position where they can't pay their bills they skip the country.

So we had a higher instance of skips in the fourth and first quarter that came through principally Retail Banking and Wealth Management. But again, that was certainly not out of line with our expectations. But what Mohammad and the team see is a very robust environment in terms of our propensity to serve customers in that area. That is reflected, to some degree, in our first-quarter numbers. The strength of our franchise across Saudi, the Emirates and Egypt puts us in a good position to serve where many others simply can't.

An area where we are stepping up to take more of our actual weight in the marketplace, from a competitive perspective, is Mexico. We have 13% of deposit share in Mexico but less than 7% of actual customer base. The key focus for Nuno Matos (CEO Mexico) and the team right now is just simply getting to your market weighting in terms of customer market share across products like, in the retail banking space specifically, mortgages, credit cards and unsecured lending. What we have done over the last three years is rebuild, from the bottom up, our ability to do that business – not just from a crime compliance perspective, but also in terms of our ability to do that business well. Part of that was dismantling a fairly dysfunctional Consumer Finance business on the back of Household and rebuilding something that is fit for purpose in the Retail Banking space.

Mexico certainly has the potential to be a third, very successful Retail Banking and Wealth Management market for us, as well as being a good market for Global Banking and Markets and Commercial Banking. There's a long way to rebuild, but progress in Mexico in the first quarter was very encouraging.

Then, in Asia, it's exactly as Stuart said on the call. We have continued to build presence and build market share where some of our competitors have found it important to retrench into domestic markets, either because they found Asia just too difficult or they have had to re-focus, to conserve capital or rebuild capital in domestic markets. I think a couple of examples of that are manifested in the pretty good numbers coming out of the French banks this week.

Chris Manners

Are there any particular products or geographies in Asia you would highlight to us where you have been able to press your advantage?

Iain Mackay

There's mainland China. Again, one deal doesn't make the franchise, but you saw the very significant M&A transaction coming together in China in the first quarter. There is Payments and Cash Management. We have improved our standing both in Debt Capital Markets and Equity Capital Markets over the last two years, and we are maintaining and continuing to build on that. We've maintained market share in a very difficult market in Global Trade and Receivables Finance. Volumes are down significantly – and by that I mean in the high twenties and low thirties, and our revenues are down about 9% in that area in Asia. Across the ASEAN countries – Singapore and Malaysia, not Indonesia – we have improved revenues and improved profits in the quarter.

Rohith Chandra-Rajan, Barclays

A couple from me as well. The first one was just on trade, which you commented on in your response to Alastair's question earlier in terms of the currently challenged profitability. It was discussed in a bit of detail on the call in relation to the margin differential between the documentary and the structured parts of the business. I just wonder whether you can give us a little bit of insight in terms of the current business mix, the mix between those two and the margin differential – and how important that changing mix could be in the next year or so.

Iain Mackay

That's a good question, actually. I think I'll have to come back to you on that one, because the mix across different components of Global Trade and Receivables Finance is something I have not necessarily looked at in great detail. I tend to look at the business in its entirety and the margins. The margins have been very stable in 2015 and into 2016. Again, I think that's by virtue of the fact that we have the propensity to serve where many others haven't.

Rohith Chandra-Rajan

Okay, I guess the reason I was asking is because Stuart flagged it as potentially margin-positive. I was just wondering to what degree that changing mix could be margin-positive.

Iain Mackay

The business is heavily structured, but, to the extent that there's evidence that supports that at the moment, it's probably more about supporting margins where they presently stay by compensating lower-margin business in the wider Global Trade and Receivables Finance franchise. But let's come back to that.

Rohith Chandra-Rajan

Then the second one was really to clarify your commentary on Basel IV. You flagged increased uncertainty, and obviously we've had a lot of consultation papers over the last few months. I was just curious to know whether your increased uncertainty is more on timing, a potential impact or a combination of the two.

Iain Mackay

My increased uncertainty was because the last time we spoke we did not have a review of IRBA going on. That's what informs my increased uncertainty. I think the uncertainty is with respect to how FRTB finally lands – because it hasn't finally landed yet. The same is true on operational risk and the same on standardised approaches for credit risk. I don't think uncertainty has increased or decreased between when we spoke at the end of the year and now.

What is largely new is the consultation that is out on IRBA. Again, what I personally find a little bit perplexing is hearing senior policy leaders saying that this is not about increasing capital in the banking sector. If you were to take the consultations as presently drafted and implemented them without change, banking outside the United States would grind to a halt. If you simply take what's presently out there for consultation and add them up, for banks that apply Basel III, banking would grind to a halt outside the United States. The numbers are massive, which is why I think most people believe they are not going to land where they land today.

The level of concern now being expressed by the ECB and by the European Parliament on this is interesting. I think we still have a bit of work to do – quite a lot of work to do – in terms of our engagement as a firm and our engagement as an industry in order to get to the goals the Basel Committee have set out, which are greater comparability, improved risk sensitivity and reconciling that without more capital in the banking system as a whole. Everybody recognises that there are going to be winners and losers – and winners and losers across each of the four major consultations that are out there. That underlying theme about there not being significantly higher amounts of capital in the banking system is largely at odds with what is contained in the consultation documents presently.

There remains a significant amount of work to do to get beyond that. The comment around increased uncertainty is simply informed by the proposals on IRBA, which again is just slightly odd.

Chris Manners

If the consultations were to land as drafted, unlikely as that may be, do the PRA have enough flex within Pillar 2A and within other things they might be able to give you relief on – to mean that, even if the consultations came in as written, which obviously is highly inflationary, HSBC could, through UK supervisory flex, end up not having a capital impact? Is there enough leeway?

Iain Mackay

For the system as a whole, based on how the proposals are drafted, I don't think that would work. The PRA have been very clear about how they would use Pillar 2A offsets. I think it's quite interesting, we're not allowed to talk about Pillar 2B, of course, but it would be interesting to see whether they would apply similar offsets to Pillar 2B, for example. That certainly hasn't been expressly discussed, because they view Pillar 2A in terms of capturing risk which otherwise would be assessed through Pillar 1. That, per se, is not the purpose of Pillar 2B.

If you take the Pillar 2A of HSBC and all its competitors and add it all up, it doesn't come to a small fraction of what you add up for the possible impact of standardised, IRBA, operational risk and the market risk components. You sort of have to put yourself in a position where you either believe that there will be no flex off the current consultation, in which case I think we're all pretty much stuffed.

On that, I'd add that if we're all stuffed, then we're less stuffed than everybody else, because we generate capital and we have multiple means by which we can manage capital to overcome the obstacles that have been put in front of us sooner than anybody else, frankly.

Andrew Coombs, Citibank

I just wanted to return to the loan-loss charges and, in particular, slide 8 of the quarterly presentation. You gave the useful slides doing the reconcile between Q1 in 2016 and Q1 in 2015 as a $690 million increase. You talked about the $0.1 billion of metals and mining charges on two counterparties, which explains Australia. You took about another $0.1 billion on oil and gas. That's what you drew out from the appendix. Yet if we take UK, US and Canada combined, we're looking at $400 million of increase, year-on-year. Oil and gas is obviously a big part of it, but it's not all of it. I'd be interested to know what accounts for the remainder – particularly in the UK and, to some extent, in the US as well.

Iain Mackay

In the US, we did a cumulative catch-up model adjustment for the run-off consumer finance book of $100 million. It is not a reflection of deteriorating underlying quality, but an update to the model, cumulatively. We're busy rebuilding models in the US and, in the process of doing so, we identified an update we needed to process. That's $100 million there.

Again, when you look at the totals in the first quarter and compare the first quarter to last year, Brazil is a significant feature of that- a very significant feature of it. Then specifically within the UK, we saw slightly higher collective provisions within retail and, across a number of sectors, a small number of individual provisions on large corporates and in commercial banking, more so in large corporates.

I think the other thing to bear out is that within Global Banking and Markets last year, we had credits coming through in terms of reversals of previously provided accounts coming through in the first quarter of last year against charges against individual names in the first quarter of this year. That was largely within the European environment and Asia, actually. We had a $40 million credit coming through in the first quarter of last year against a small charge in the first quarter of this year in Asia.

Andrew Coombs

On the update of the models in the US, this is an ongoing process?

Iain Mackay

The model update is, but what we captured in terms of the update that we processed this quarter is a cumulative that we do not expect to repeat.

Robert Sage, Natixis

I just wanted to ask about Global Private Banking, which I know isn't the largest part of your business. In the back of my mind, it's been a growth area in terms of the way I've been thinking about it. When you look at the last five quarters, there's been a very steady reduction both in terms of revenues and costs – though not in terms of client assets. Revenue in the first quarter is about 20% down and the costs were more than 30% down. The profit looks fine, but there doesn't seem to be much evidence of investment going on. There seems to have been an enormous erosion of revenue-margin. Looking forward from here, I was wondering what is actually happening to it in terms of modelling assumptions.

Iain Mackay

On Private Bank, over the last two years we've undergone a massive restructuring of this business. We've sold large portfolios; we've sold or closed very many of our booking centres around the world. That has been largely informed by a risk appetite around the kind of customers that sat within those businesses.

Many of the private banking customers who existed historically in HSBC have been acquired through the Republic Bank acquisition in the early 2000s. When you looked at that customer base against a Global Standards perspective, it didn't work in terms of our risk appetite – at all. Notwithstanding the ability, conceivably, to get them to the level of customer due diligence and knowledge, from a risk appetite perspective we didn't feel that fitted in with our HSBC perspective.

That restructuring has been massive. We've gone from well over 50 booking centres to less than 20. Those booking centres are largely focused in markets that we have a strong presence in with respect to Retail Banking and Wealth Management, Commercial Banking, and Global Banking and Markets. Again, Hong Kong and the UK are the two principal areas. When you look at the $4 billion of net new money we brought in, in the first quarter, it largely came from Europe, principally through the UK.

From here, we have not quite completed the restructuring and de-risking of that business. There are still a couple of portfolios and offices we are going to exit from. That work is reasonably well advanced. It is not material in terms of the context of the Group at all. It is, as you can see in the numbers, material in the context of the Private Bank. As we complete that work, we'll continue to focus on bringing in net new money with customers we know and customers that fit our risk appetite, and we will build on what we have done in Europe.

The areas we see for growth here are principally Europe, Asia – specifically within Asia, Hong Kong and Singapore – and, to a lesser extent, within the United States. We will maintain a Swiss Private Bank. We have a broad base of longstanding HSBC customers who have been with us for many, many decades, who bank with us in Switzerland who we know well and who certainly meet our risk appetite and Global Standards requirements.

The reshaping of that business will be largely complete by the third quarter of this year, and then our focus will return wholly to building up a Private Banking business which will never be a particularly significant part of the Group, but we do think it can certainly achieve – and still does achieve – reasonably good returns. We can improve on the returns, but it is also an important part of the offering to the customer base within Commercial Banking as well as within Global Banking and Markets – and, in certain instances, the customers migrating from the Premier offering within Retail Banking and Wealth Management to the Private Bank. But the largest connectivity is between the Commercial Bank and Global Banking and Markets customers.

Guy Stebbings, Exane BNP Paribas

I have a couple of quick questions. The first one is on the scrip take-up. The latest scrip take-up was below historic averages and below the long-run assumption. I wonder whether you can give us anything about how we should think about that going forward.

Iain Mackay

I wouldn't read too much into it. Over the last five years we've seen it as high as over 50% and as low as 8%. It was 9.9% on the fourth interim dividend. It's a function of where the price is struck on the option for the scrip versus where the stock is trading. When the stock trades above that, we get great take-up; when the stock is trading below it – and guess what? It's trading below it just now – there's very limited take-up. There is significant volatility.

The historical average is a little bit above 20%, and that is how we tend to plan for it. If there is a new trend established, we'll reflect that in our planning, but I wouldn't read too much into that. We've seen lower than 9.9% on several occasions over the last five years.

Guy Stebbings

Okay, thanks. Then just a point of clarification on the underlying tax rate of 25-26%: how should we think about that in the longer term? Should we be thinking about it ex any litigation or anything like that?

Iain Mackay

Guidance on the effective tax rate (ETR), given the 8% surcharge on banking profits in the UK now, we have historically guided an effective tax rate of 21-22%. Between 24-26% is more appropriate now. That is largely informed by our expectations for profitability of the UK business and the tax contribution out of that as a proportion of the overall profit of the Group.

Alastair Ryan

On the North American business, hypothetically or potentially, when would be the first time you could take any capital out of the North American Holdings business?

Iain Mackay

Hypothetically, 2017. The reason I say 2017 is in the CCAR submission for 2015/2016, we had a discussion with the Federal Reserve about surplus capital in the United States. The Federal Reserve were very amenable to us including a dividend proposal within the nine-quarter capital plan you submit under CCAR. There are two windows within which you can submit capital actions: a four-quarter window and then the second five quarters. They advised us to include it within the second five quarters.

As we continue to make progress in the US business, which we saw in the first quarter, which – along with Pat and the team – we certainly intend to sustain, we can have a good conversation with the Federal Reserve as we submit CCAR next year. If we were to get the nod on bringing a dividend in to the four-quarter window, then we'd have confidence about getting some of that surplus capital and beginning to move some of that surplus capital out of the US in 2017 and into 2018 and beyond.

Clearly, the view is building a business in the US that can not only self-capitalise – and I think when we get to self-capitalisation and get some of the litigation that sits in Note 40 behind us – then the Fed will be much more amenable to us, one, extracting surplus capital progressively and, two, paying an ongoing dividend from the US business, which we haven't seen for eight years now.

Ed Firth, Macquarie Group

I actually had a more strategic question, if that's alright. One of the enduring themes we've had for the last four or five years is central banks really pushing banks to lend more money or trying to get them to lend more money. And I'm struck by your key targets or your key outlook. The 70% loan-to-deposit remains an enduring theme also for HSBC. There are two points on that. One is it must be costing you quite a lot in terms of your return. If we're looking at your 10% target, I guess there must be a big chunk negative in there if you're maintaining that loan-to-deposit ratio. Have you done any numbers or can you give us any guidance as to how much of your profitability is depressed by holding it at that level as opposed to, let's say, 100% or a market average?

My second question is is there any appetite in HSBC at all to change that in terms of actually pushing a bit more on the assets side of the balance sheet, which I guess is where the money is to be made at the moment?

Iain Mackay

Actually, not. You're not making much money by putting your balance sheet to work here. Present lending, certainly in Global Banking and Markets and Commercial Banking, is not where you're making sustainable returns within the banking industry. You're making it off product streams and services that put fees on top of the balance sheet that you're making available to your customers.

Our goal around the loan-to-deposit ratio is, 'No more than 90%.' 70% isn't a sacrosanct number for us, but when risk comes on we have this uncanny knack of customers wanting to put their money with us. That's what happened in the first quarter; it's specifically what happened in Hong Kong and Asia, where we saw a deposit in-flow of a significant nature.

By the same token, we've spent five years de-risking the portfolios of the Group around the world. We have maintained a prudent risk appetite we don't want to bang a whole bunch of business onto the balance sheet just to make revenue that flushes down the tubes later. We've seen a couple in our peer group who have done just that and are suffering the consequences of doing that.

We know what business we like; we know what business works; we know what customers we can serve well and how we do that within our risk appetite. If you think about the cost of this, if you were to look at Balance Sheet Management revenues through the period of the financial crisis and before, that gives you some indication of the amount of revenue that we lose by maintaining a very strong loan-to-deposit ratio and what that means in terms of impact on return on equity for the Group. It is not negligible. If you looked at revenues coming through Balance Sheet Management six years ago, it was over $5 billion. It was $2.8 billion last year. As Stuart mentioned on the call, we'd expect to be somewhere between $2.4 and $2.7 billion this year – unless of course the Fed gets adventurous and thinks it's a good time to put up rates, which would certainly help us.

A question people put to us is, 'When the Fed puts up rates, that's going to create credit-cost risk for you.' That's now not our view. Again, it's informed by the conservatism with which we do underwriting in the markets in which we operate. In terms of how we stress affordability and repayment under mortgage underwriting, for example, we stress customers in the UK and Hong Kong to 350-400 basis points on underwriting against current rates. That is more than we would anticipate in terms of normalisation of US dollar and sterling rates.

So, yes, there's no doubt about it: there is a cost to us in terms of returns on doing that. Historically, analysis has suggested that, if you go gangbusters and throw it all out there, it tends not to return in terms of risk-adjusted revenues. Is there perhaps a spot between where our appetite sits and that inflexion point where you can generate more revenue in the short term but it really doesn't contribute to the long-term returns of the Group? There probably is but, in this environment, it's probably not, in our view, the right time to test that.

Ed Firth

Just a related question: I guess the key change recently has been negative rates at the European Central Bank, and I guess you must be a bank that is depositing quite heavily there, or has been in the past. Is that something you just have to take on the chin or are there other ways you can get round that? Are there other structures you can do to get around it?

Iain Mackay

Non-operational deposits. So, financial institutions, they get charged for non-op deposits with us, aligned to the negative rates within ECB. The same is presently under review in Japan, so, for the two markets which have negative policy rates, financial institutions that hold non-operating deposits with us get charged for that.

What we are also doing is looking at corporates and, in the corporate space, we have agreed with our customers. We've set an operational deposit level for those corporates. If they put more than the operational-deposit limit with us, then they are on notice that they may be charged for that. We don't presently charge for that but they are on notice that they may be charged for that. And that is principally just to encourage people to stop dumping money with us that we can't make use of and get no liquidity value for.

So, we don't take it on the chin within the environment where there's a negative rate and, where people leave deposits with us that have no liquidity value to us, we charge them for it.

Ian Gordon, Investec Securities

On the call when you were talking about NIM, you were discussing broad stability by geography but some headwinds at Group level, driven by mix and TLAC issuance and so forth. Just in terms of where we see the impact of TLAC issuance, does that sit in Europe or is it spread?

Iain Mackay

So, we're, for the moment, issuing TLAC out of the parent company and then down-streaming it to the operating subsidiaries. So far, of the 10.5 billion issued, we've down-streamed it to Europe, the Middle East, the US and a small amount to Hong Kong.

Ian Gordon

Thanks. The second one: North America. Following up on your comments to Alastair, on the call, you mentioned one disposal in April. Could you tell us where that was priced relative to carry value?

Iain Mackay

97 cents on the dollar above book value, so we made a profit on that transaction. Small, but a profit.

Ian Gordon

And in terms of the outlook?

Iain Mackay

We transferred $5 billion to held-for-sale in the first quarter, and our expectation is that that $5 billion at least will be delivered on this year. The market for this paper remains robust. What we are left with, interestingly, is probably the best-quality paper that survived the housing crisis in the United States and, interestingly, the best-quality paper has got the least attractiveness to the buyers that we have cultivated over the last three years. But the goal for the team is to see the $17 billion of unpaid principal balance gone by the end of 2017. I think we'll get pretty close. I think we've got a pretty good chance of getting there but we've got $5 billion in the hopper for between now and the remainder of the year, and I think we will certainly accomplish that.

Ian Gordon

And just in terms of the cost attached to that, the cost performance appears to have been, bluntly, better than what was described four, five years ago in terms of stranded costs or non-sustainable costs, if I can put it like that.

Iain Mackay

The team that has been managing this portfolio down for the last five years have done, in my view, an absolutely outstanding job. They've managed the cost equation to service this debt and serviced the customers tightly. They've managed the balance sheet in terms of getting high-cost debt, because this was all debt-finance stuff, so they've managed the asset-liability aspect of this incredibly well. They've cultivated a great population of buyers. I think what we would like to see is 1) take the CML legacy portfolio out of the equation for CCAR, because the Fed has used it as a means to assess higher-stress capital requirements against us, so the sooner we can eliminate that, the better.

Another aspect is that Consumer Finance in the States tends to be a state-by-state-regulated business, and we've got almost 140 entities spread across the US supporting. And if you've got one loan in the state, guess what – you need the entity to support it. So, the sooner we can extricate ourselves from individual states and start winding down the infrastructure, there's a significant cost component, which is reflected, clearly, in the P&L of the CML book. That's a business that now…it hasn't consumed capital, beyond the capital that presently sits in the business, for more than three years now. So, it returns a small profit before tax, so it doesn't drain any of the capital resources of the Group, which it's been wont to do in the not-too-distant past, but the goal is to try and get this business gone between now and the end of 2017.

Ian Gordon

And then, sorry, since you just mentioned it, can I just check the FSCS charge in Q2? Is something between $0.1 and $0.2 billion the right number?

Iain Mackay

Yes.

Ian Gordon

And then, finally, this is a real dull question but just in terms of the below-the-line deductions, excluding further AT1 issuance that you've talked about and will come when it comes, there's no basic change to the Q1/Q3 weighting of the deductions based on existing coupons, is there?

Iain Mackay

No, the variable that's going to come in between profit attributable to our ordinary shareholders and profit after tax is the increase in AT1 issuance. AT1s are accounted for as equity instruments, so that is the variable that will sit between profit after tax and profit attributable to ordinary shareholders.

Ian Gordon

Yes. So, the existing profile is as is; i.e. Q1/Q3 higher.

Iain Mackay

That's right.

Steven Chan, Haitong

I have two questions. One is about Hong Kong. Recently, the SFC has actually terminated your Licence for your Private Banking business according to the local news. Although you guys are doing an appeal, so I'm not sure how that will affect your business. Are you worried that will affect your revenue going ahead?

And secondly, in BoCom's conference call, I think the management were saying that they have recently appointed Peter Wong of HSBC to be the vice chairman, and they say that they're probably going to have more cooperation between HSBC and BoCom. So, my question is: will that affect your strategy in China especially? You have a big plan in Pearl River Delta, so, if you have more cooperation with BoCom, will that threaten your development or your expansion in Pearl River Delta?

Iain Mackay

No, none whatsoever – absolutely none. On your first question, the newspapers are not entirely accurate. The Private Banking licence that they have proposed removing is a branch of the Swiss Private Bank. Our Private Bank in Hong Kong is actually divisionalised under HBAP – The Hong Kong and Shanghai Banking Corporation. So, our Private Banking activity in Hong Kong is driven through the Bank, not through a branch of the Swiss Bank.

But the matter which is being pursued by the SFC, as you probably have read in the newspapers this week, it is in the Court, being appealed by us, both in terms of the fining and the size of the fine that they propose to assess against us, which I think was US$78 million equivalent.

Steven Chan

Okay. Because the management of BoCom are saying that the appointment of Peter Wong to be the vice chairman of BoCom is to have more cooperation between BoCom and HSBC. So, what sort of cooperation or what sort of future business strategy do you see between you and BoCom in the coming years?

Iain Mackay

The cooperation is mostly about assisting BoCom in supporting its customers offshore. For example, one of the things that we mentioned in the call on Tuesday was the development of our own credit card business in mainland China. We were in a joint venture with BoCom in credit cards. That joint venture will revert to BoCom. And the expertise that we've provided within BoCom will now be focused on the development of our own credit card business within China. The enhanced cooperation to which I suspect the BoCom management is referring is the support that we provide BoCom in terms of supporting their customers internationally, where we clearly have a robust capability to support those customers internationally, whereas BoCom, with a largely domestically focused franchise, certainly looks forward to our assistance in that respect. That's, broadly speaking, the nature of the cooperation enhancements that I believe the leadership is referring to.

Sandy Chen, Cenkos Securities

Two questions: the first is really just looking at slide 12 of the deck and comparing RBWM and GB&M. The target that you've set going from 3.8% in the first quarter of 2016 to 6.3% for RBWM versus the target moving from 2.1% to 2.7% in GB&M, is it right to think about it, for RBWM, that you're looking at the cost side with a relatively stable set of top-line income expectations, and you're looking at digital really significantly bringing down the operating costs on a per-RWA basis? And then, for GB&M, is it more about Samir finishing the rest of the 40% of the RWA reduction?

Iain Mackay

Within our Retail Banking and Wealth Management Principal business, which is basically Retail Bank excluding the US runoff portfolio, that is part of it. Another part of it is the disposal of Brazil. Disposing of Brazil takes the return on risk-weighted assets to this business to more than 4.5%. That's still not 6.3% but it's better than 3.8%. There are a number of components. There is not a significant contribution from RWA reduction within Retail Bank. The focus of John (Flint, CEO RBWM) and the team is both on the revenue line and on the cost line. So, he has a number of programmes in place to extract significant costs from the Service Delivery costs of RBWM, but also looking at continued expansion of the Wealth Management business, not only in Asia but also in Europe, to a lesser extent in the Americas.

Part of it is also informed by recovery in Mexico, which is a high-margin Retail Banking and Wealth Management business. So, as I mentioned earlier, just building back to an appropriate share of market based on our distribution capability in Mexico will help contribute towards the overall improvement in returns coming through the Retail Bank. So, over the next two years – or less than two years now – it is an aspect of both incrementing revenues as well as managing down the cost base within Retail Banking and Wealth Management.

The Global Banking and Markets business is, yes, it's partly about improving the overall capital allocation within Global Banking and Markets, and part of it is taking capital out of Global Banking and Markets. We set out a goal of having approximately 30% of the overall capital allocated to Global Banking and Markets measured in terms of risk-weighted assets. We're still four or five points above that, so we've still got more to do in terms of extricating capital from Global Banking and Markets, but also just improving the overall profitability of some of the customer relationships that sit within that.

There is more work to do in the cost and structuring basis within Global Banking and Markets. That is not the major contributor to it – Global Banking and Markets already sits in a cost-efficiency ratio of 52% – but there is, nonetheless, still work that Samir is doing in that regard. At 2.1% on a pre-tax basis, the

Global Banking and Markets business is certainly covering its cost of equity within the firm, but it's still got quite a lot of work to do to get to the 2.7% that we've targeted.

Thank you very much for your time this morning.