Edited Transcript

Post-3Q 2016 Earnings Release

Meeting with Analysts hosted by Iain Mackay, Group Finance Director

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Corporate participants:
Iain Mackay, Group Finance Director
Richard O'Connor, Global Head of Investor Relations
Tony Bloomfield, Chief Accounting Officer, Asia-Pacific

HSBC

Iain Mackay, Group Finance Director

Welcome. From the firm's perspective the third quarter represented progress again, clearly in difficult operating conditions, continued traction in terms of cost management, working towards the upper end of our targets from a cost-savings perspective. Obviously happy with the progress that we made on capital, both in terms of capital generation from operations, the disposition of our business in Brazil, and the progress represented by the regulatory changes with respect to BoCom. Clearly still much to do. Difficult operating conditions for the industry and for ourselves presently, but we remain very much focused on those aspects that are within our control and continue to deliver improvements in that regard.

Gurpreet Singh Sahi, Goldman Sachs

On US dollar assets, so we know the geographical breakdown, and we can figure out that most of the assets in Hong Kong and US would be US dollar/Hong Kong dollar-linked, but what outside of those geographies should we look out for when we think about rate rises and impact on the asset base?

Iain Mackay

Middle East and North Africa economies to a significant degree are influenced by the US dollar, and obviously heavy fossil fuel economies, priced in dollars, traded in dollars. So the Middle East and North Africa – not every jurisdiction. I think you can probably exempt Egypt from that particular categorisation, but the others are certainly strongly linked to the US dollar. And although not directly traded, both Mexico and Canada. If you watched the development of the polls in the US presidential election, depending on how they were progressing, you saw very significant movements in terms of Mexican peso/US dollar. It tracked, actually, quite closely.

So there are a broad base of our markets which are dollar-linked. Those which you could clearly exclude would be sterling and euro. But beyond that the reporting currency of the Group is the US dollar, because the functional currency in so many of our operations is the US dollar.

Gurpreet Singh Sahi

And then if there is a steepening of the yield curve, how should we think about the impact?

Iain Mackay

Positively.

Gurpreet Singh Sahi

On Balance Sheet Management, how should we think about it? Because if you look at it historically, the Balance Sheet Management revenues have been broadly stable, despite the yield curve having flattened a lot.

Iain Mackay

I think what you should see being reflected, coming through the global businesses, with, for example, let's assume optimistically for the moment that we get a 25 basis point uplift in the Fed rate in December, over the course of the following months we should see some benefit to that. Obviously when we got a lift last year/earlier this year, it doesn't have a huge impact immediately, but it filtered in over the coming months as businesses re-priced and how that works through the yield curve and our asset base – asset and liability base. But if we were to see an uplift, we would expect that to provide some opportunity for us, both in terms of how we manage the corporate surplus through Balance Sheet Management around the world, but also in terms of how it would reflect on cost of funds and value of funds within the global businesses. So, positively would be our view and our experience.

Gurpreet Singh Sahi

There was some focus on the 'Other' revenue, the 'Other interest' segment within the business, not explained in any business, and then the sequential negative movement of that. I just wanted to understand, is that in any way related to the other businesses?

Iain Mackay

No, the main drivers of that is fair value movements and own credit spread, and the offset is reflected in the global businesses, mostly Global Banking and Markets.

Richard O'Connor, Global Head of Investor Relations

But we also talked about increasing cost of TLAC, about $160 million, included as an impact as well.

Katherine Lei, JPMorgan

In Hong Kong, there are a few things happening. First is the stamp duty.. So, on that one, will you grow your, say for example, mortgage book in Hong Kong continuously by taking market shares from other banks? So, presumably, primary markets or new loan generation on the mortgage book is going to slow down, but the thing is that what you can do is that you take the mortgage after the first two years; then you can take it from your competitors.

Iain Mackay

To be clear, we have, both through Hong Kong Bank and Hang Seng, quite a robust share of the mortgage market in Hong Kong already, and that share has not changed to any significant degree, up or down, since I was CFO here, Sarah was CFO here, or Kathleen being CFO here. It remains quite consistent. I think in terms of any real impact from the stamp duty changes, we serve really the full range of borrowers within the mortgage market in Hong Kong, and so though this is certainly targeted to slow down the higher end of the market – I mean, we'll have to see how this develops, but by virtue of the fact that we do serve the broad segment of the borrowing community in Hong Kong, I think this continues to present just an attractive part of the business for us in Hong Kong. But we will just have to see how this plays out.

Katherine Lei

So, does that mean you expand cross-selling of your existing mortgage borrowers instead of aggressively competing for more market share?

Iain Mackay

No, I don't think for the moment this is going to necessarily connote any particular change in behaviour. I think the average product that we have per retail borrower in Hong Kong is about five or six products, so there's a current account, deposit account, credit card, mortgage product being an anchor very often, and Wealth Management products, so funds for example. So there's not really a change in behaviour by HSBC connoted by the change in the stamp duty in Hong Kong, and obviously we get a great deal of insight into the market here, and as the impact of that stamp duty change takes effect, I'm sure we'll respond accordingly.

Katherine Lei

Then the other question I have is on costs-to-achieve – how would you guide the market and analysts like us?

Iain Mackay

I would guide you the same way as we guided you in June of 2015, that we're targeting the upper end of the range from a cost-saving perspective, and what we had said back in June of last year is that we would expect to incur costs-to-achieve in the $4 billion to $4.5 billion range, assuming we achieved $4.5 billion to $5 billion of cost savings. If we achieve at the upper end of the cost savings, then we would expect to incur costs-to-achieve at the upper end of the costs-to-achieve range. Broadly speaking, the ratio between the costs-to-achieve and the cost savings is about 1 : 0.8. So for every dollar saved, it usually takes about 80 cents to generate that saving.

Katherine Lei

On BoCom, because there are some capital savings, would you consider to do another share buy-back?

Iain Mackay

Well, it's certainly changed the regulatory capital for the Group at a consolidated level, and that, in our view, gives us greater flexibility. But there are a few other things to work through. So the guidance, what we talked about in terms of the sustainability of the dividend and our approach to buy-backs when we released the half-year numbers in August, remains the same. So there's really nothing new on that front for the moment, and we'll keep everybody updated as we work through a couple of other things, which are frankly not within our control, and that's more on the regulatory side, with respect to provisions for Basel III.

Dominic Chan, BNP Paribas Securities

You did really well on RBWM in Asia, in Hong Kong in particular, in the third quarter, but when I look at the loan growth it actually declined by 1% in the first nine months of the year, specifically on the commercial side of things. So I'm just wondering, are you losing market shares on the corporate banking side to your competitors, like Bank of China?

Iain Mackay

No, actually what is reflected there is broadly lower levels of Trade finance coming through the book. So there is significantly lower volumes of Global Trade and Receivables Finance business in the world. Over the course of the last six to eight quarters, we have not only retained but we've built market share in that respect, both through plain vanilla as well as structured trade and receivable financing products, and that's kept the revenues in pretty good shape, although we certainly did see a little bit of a falloff in those revenues between the second and the third quarter of this year. But market share we've kept very consistent and have, in actual fact, grown over the last five or six quarters.

Dominic Chan

How should we view the trend going into the fourth quarter and next year? Are we going to see further decline from here?

Iain Mackay

There is not much sign of Global Trade and Receivable Financing picking up to any significant degree. I mean, we don't necessarily see it falling off the edge of a cliff either, but nor do we see a particularly strong progression from here. But one of the things that the business has focused on is just the diversification within those product lines that support international trade and investment, and one of the areas where we've been particularly successful has been Global Liquidity and Cash Management, formerly known as Payments and Cash Management, and we've consistently grown the revenues and market share in that space over the same period as Global Trade and Receivables has been under pressure. So a good product there, continue to grow it. But specifically on Trade, it continues to be difficult, with overall volumes still heading in the wrong direction.

Dominic Chan

But in net interest income, clearly you did really well on non-funding income. Could you tell us why specifically you did really well in that area?

Iain Mackay

In net interest income? It comes back to the cost of funds. We are subject to movement in interest rates in jurisdictions in which we operate, and we manage the corporate position and funding position by each jurisdiction in which we operate. So where we saw, for example, some compression in UK mortgages, we actually saw lower cost of funds in the UK, where we attracted deposits and saw overall a lower cost of funds. We actually saw a little bit of margin expansion in the UK. We also saw some margin expansion in Mexico and Argentina, with rate movements in that market, and this is all excluding the effect of Brazil. Brazil going out had a slightly adverse effect on net interest margin, because that tended to be certainly a high loan impairment charge environment. It was also a fairly high yield environment. Within Asia overall, again, we had a traction in the deposit base, with much lower cost of funds. Overall, the view there in terms of what we saw coming through net interest income was fairly positive in the quarter.

Tom Rayner, Exane

Can I just come back to the question that came up on the call yesterday, just about the capital that may or may not be trapped in subsidiaries around the Group? You mentioned you'll be focusing on capital actions to try and make sure that such surpluses get their way to the centre and become available for distribution, if that's what you decide to do. Can you elaborate on what those capital actions might be, and just give us an idea of the sorts of things you're thinking about?

Iain Mackay

Probably the best example, and certainly where we have the most significant amount of surplus capital, is within our US holding company, and as we talked through at the half year, all the US banks that are subject to CCAR are required to submit an annual capital plan as part of that CCAR, and in 2016 we got no objection from the Federal Reserve for the inclusion, for the first time in many years, of a dividend from our US holding company to the Group. We would expect that dividend to be paid in the late first/early second quarter of next year, and then as we submit CCAR and the incorporated capital plan in 2017, as we continue to run down the final elements of the sub-prime portfolio, the CML portfolio, we'll continue to make application annually for right-sizing the capital base to the size of the business and the risk of the business in the US. And that, by virtue of the CCAR process, will take a number of years to accomplish.

We have a not-dissimilar approach to other subsidiaries around the world, where those subsidiaries are self-capitalising and have distributed-profit capability, as we look at the local regulatory capital requirement, and that's changing presently as many jurisdictions around the world are implementing Basel III in its various forms. And we take into consideration regulatory requirements, local management buffers, and then, to the extent that there is any surplus to that, that is remitted back to the parent company.

Now, there are a number of subsidiaries around the world where there are not necessarily a restriction around the specific capital requirement, but some of the lending obligations and cross-border lending obligations that we have require us to hold slightly more capital. So one example of that is mainland China, where we have some surplus capital but we'll have to work fairly closely with the China Banking Regulatory Commission (CBRC) to create the right conditions to dividend that to the Hongkong and Shanghai Banking Corporation (HBAP) in the first instance and then hopefully from there up to the parent. In Switzerland, we are holding capital requirements which are somewhat surplus to requirements on the back of right-sizing the European Private Banking business. We've disposed of a number of portfolios. We've exited a fairly large number of the customer base within that, and within that legal entity we have some surplus capital, and we're presently working with FINMA to understand and create the right conditions to pull that back into the parent company.

Where it goes beyond simply the discretionary dividend – and even the discretionary dividend now in the vast majority of cases requires the approval of the local regulator – it requires very active engagement by our CFOs and our regulatory teams around the world, with the regulators, to ensure there's a complete understanding of the local regulatory capital requirement, the capital-generating propensity of the business, and then the propensity of that business to pay dividends to the parent company. And that, broadly speaking, on a day-to-day basis, is the nature of the activities we undertake.

Now, this last quarter, you saw some much more fundamental capital management activities, in terms of the disposition of the Brazilian business. We looked at that business and concluded it was not a market in which we could succeed, and extricated ourselves from that market through a very successful sale of the business, releasing about $40 billion worth of risk-weighted assets and the capital associated with that. So there are a wider range of smaller activities of that more strategic variety, which we continue to consider and implement, but it would be fair to say there are a very wide range, some very small and incremental and some more game changing, in the capital management actions category that we take.

Tom Rayner

Listening to that, it sounds to me as if, even if the HKMA resisted for now you moving any of the 100 basis points from the BoCom regulatory change, even if the HKMA wanted you to hang on to that in Hong Kong, it's not going to be a constraint on what you actually do. And with the consolidated ratio sitting currently 90 basis points above the top of your range, I guess this whole focus on whether or not we see a buy-back next year is going to keep being asked. What I wanted to ask you is what do you consider when you're thinking about buy-back versus maybe special dividend? Because HSBC shares are trading a little bit above book value already. What's your thought process on whether you might choose a different way of distributing that surplus?

Iain Mackay

So when we do contemplate such actions, one of the things we think about is dilution. And one of the ways to manage that dilution is through a share buy-back, because obviously the scrip each year contributes a little bit more to the overall dilution for the ordinary shareholders. That is one of the considerations. I'm not entirely persuaded as to the value of a special dividend, in our particular circumstances when you look at our share count which is about 19.7 billion ordinary shares in circulation. But I think it would be fair to say that, when we do contemplate capital actions in the opposite direction, namely the return of capital to our shareholders, there's a range of activities considered: obviously the dividend on the ordinary shares, which we've provided guidance on, and buy-backs, but they are not necessarily the only alternatives, however they are top of the list presently, the latter being viewed more with respect to trying to mitigate some of the dilution effects of the scrip.

Raul Sinha, JP Morgan

Can you talk a little bit about the FX hedging in place at HSBC, and what impact we might have seen on that in the third quarter, particularly with reference to the fall of sterling? And if you could touch a little bit on HSBC Bank plc. You obviously give us the numbers there in terms of disclosure, but the sterling revenues you report inside the Bank, obviously, I presume, are not entirely all sterling. Some of those would probably relate to dollar denominated business as well. So could you give us some insight into what the sterling sensitivity of HSBC's P&L or revenues is? Then we can kind of work out what the sensitivity of the fall might be.

Iain Mackay

So within each jurisdiction, we try to balance both assets and liabilities from a currency perspective. Where we have a structural currency exposure, which in the vast majority of instances represents the Group's investment in that subsidiary, and where we think there is an opportunity as well as the liquidity in the market to hedge that exposure, then we do so. Presently, the only significant structural FX position that we hedge is the sterling structural FX position, and that broadly is represented by our net investment in the UK Bank. And what we seek to do there is hedge to the extent that that net exposure is adversely impacted then the hedges that we put on at a Group level would generate sufficient income to offset the impact on capital from the currency translation. That strategy in the UK has been very successful so far, meaning that the gains that we've generated on the structural FX entered into at the Group level has either set off or more than offset the adverse impact on the capital base in the UK subsidiary.

Raul Sinha

Can I ask what the size of those gains, and on which lines we might see them in in the P&L?

Iain Mackay

Well, you're seeing it actually coming through the capital line. On capital development, you see an adverse effect coming through in capital, for example, in the UK Bank and a positive effect coming through in capital at a Group holding. Broadly speaking you see the FX impact on the capital coming through on page 11. Now, that's all currencies coming through in capital, but a significant portion of that is coming from sterling, and that is hedged.

Raul Sinha

What is the real revenue base of the company in sterling terms?

Richard O'Connor

That's disclosed in the Annual Report and Accounts. It's $15 billion, out of $54 billion last year in UK revenue.

Raul Sinha

Exactly, so that $15 billion includes RBWM, which is pure sterling, and CMB and GBM revenues, but I would have assumed that some of those GBM revenues within that $15 billion number are actually dollar-denominated revenues booked in the Bank PLC in sterling terms. It's international business that you would do. So what I was trying to get at is, when we think about the impact of sterling falling against the dollar, should we apply that to the $15 billion, which in my view might overestimate the impact? Or is it a lower number?

Iain Mackay

No, I think that's the right basis on which to apply it, absolutely. And that would be the right basis to apply it in any P&L denominated other than in the US dollar.

Raul Sinha

On capital. Obviously there's a lot of debate about what you will do with the surplus, but I wanted to ask you about good old fashioned loan growth and ability to generate returns from that excess capital. I think you've pretty convincingly moved away from that progressive dividend ambition that we used to have previously with HSBC. Is that something that could come back, firstly? And secondly, if it doesn't come back, and we're still at 51 cents of dividend, wouldn't you actually start thinking about deploying some of this excess capital that you find yourselves with into revenue-generating assets that could actually improve the return on equity from the current 8%?

Iain Mackay

To be clear, most of the employees in this Bank actually do wake up in the morning with that objective. But it has proven to be an incredibly difficult environment in which to do so, within what is and remains a fairly conservative risk appetite for the Group. So it would be unfair to characterise our banking teams as sitting around, not trying to grow the business. They are actually out churning the balance sheet and putting a lot of capital to work. But we're also in the process of taking quite a lot of capital out of circulation through the risk-weighted assets reduction programme, and what clearly has been quite difficult to do has been to recycle that into focused and identified markets that we talked about back in June of 2015. So, for example, Peter Wong and the team and Helen Wong and the team in Hong Kong and mainland China are implementing the strategy around the development of Pearl River Delta (PRD), but with the rates of growth that we've got there and some of the challenges within the Chinese economy, the rate at which we are executing that is certainly slower than we had expected. And in terms of the rate of spend in terms of building PRD, that's equally reflected in the rate of capital deployment within the Pearl River Delta.

So I think appropriately at this point in time, there's a reasonably cautious approach to building that out. So the lack of growth is not through want of trying on the part of the businesses.

Raul Sinha

That wasn't the point of my question. I guess what I was trying to say is, even if you look at the Principal RBWM, in nine months it's down 2%. GBM we can put down to market conditions. Clearly CMB continues to grow very strongly. Once you finish your restructuring of the balance sheet, you'll be left with a core business that obviously can grow, and what I was thinking about is are you seeing signs of being able to invest some of that capital into that core business?

Iain Mackay

We absolutely are. You see some of that in CMB, and we see it within certain product lines in Global Banking and Markets. You see it within UK mortgages. We've grown market share in UK mortgages again in the third quarter. Part of that has been based on the fact that we expanded the use of the broker channel for accessing business, not for underwriting business but for accessing business, and that's helped us grow market share, and Stuart provided some of the details around that market share growth on the call yesterday. Again, that pattern is being repeated around the world. Mexico is another good example, where we're putting capital to work growing the business both in terms of mortgages, unsecured personal lending, as well as continuing to grow Commercial Banking and Global Banking and Markets there.

So absolutely. The good thing is the capital capacity exists in the subsidiaries around the world that we want to grow the business. And we do want to grow the business. Taking $290 billion of risk-weighted assets out was never really about shrinking the balance sheet; it was taking unprofitable business off the balance sheet and recycling that into profitable business. And what the businesses are being disciplined about is profitability of what we're underwriting. So there is absolutely no point in taking $290 billion, or even $100 billion, out of underperforming business, and putting it back into underperforming businesses. So the right discipline around that is important. And clearly the fact that we haven't recycled as much as we'd hoped obviously makes the growth in the revenue line in the balance sheet more difficult, but it also goes to the strength of the Common Equity Tier 1 ratio of the group. It is there to support the growth, as well as obviously to support returns to shareholders.

Chirantan Barua, Sanford Bernstein

On the UK mortgages: what is the aspirational market share that HSBC UK – I mean, all things equal, I understand you have got a risk appetite for the amount of brokers that you've been laying on, so what kind of share would you be comfortable with targeting, as opposed to where you are right now?

On CML, I heard you yesterday and just wanted to clarify: so you are planning to get out of CML by end of next year. It would be great to understand how you plan to do so. Is it a big transaction that we should expect, or it's natural rundown?

On Private Banking. One of the things we've understood is it's a small part of the business, we don't discuss it. So you have had asset outflows every quarter for the last four quarters, and UBS and Credit Suisse have been growing around about 3-5 billion every quarter in Asia. You're the fourth biggest private bank in Asia; I just want to understand what's happening in there - is it still a core part of your business that we talked about in the last question?

Iain Mackay

On the Private Bank first. The main area of outflow has been within the European business. I think with the exception of this quarter, we've grown Assets under Management in Asia consistently. This quarter was certainly a little bit of an aberration in that respect. But in the main outflows – in fact, this source of outflows in Private Bank has been in Europe, where we have done over the last few years, very significant restructuring of that business. We've sold a number of portfolios, we've closed a number of our offices, and we've exited a significant number of customers – mostly those that were disinclined to provide complete transparency with respect to their tax affairs. And our appetite for supporting customers in Private Banking, of whatever nationality, that are unprepared to be absolutely clear about their tax affairs, is zero. That's really what's driven the reduction in Assets under Management within the Private Bank.

We are very much at the inflexion point of completing most of the restructuring within the Private Bank in Europe, and certainly the focus for Peter Boyles, who's the CEO of that business, and his team is very much back in terms of putting capital to work and growing that business again. But we've done very significant derisking and restructuring of that business over the last two and a half/three years.

Chirantan Barua

Asian outflows this quarter - what was it regarding? We had very strong performance in our other Private Banks; that's why I was wondering why you have asset outflows this quarter. Is it any specific domain, any geography?

Iain Mackay

Not that I'm aware of. We'll dig into that and come back if there's any specific driver, but I had a quick chat with the CEO here on this yesterday, and there's no particular driver in that respect.

On CML, as you probably observed, we've been selling virtually every quarter for the last three years tranches of anywhere between $300 million to $750 million plus of unpaid principal balance from that portfolio. Under US GAAP, in the second quarter I think it was, we classified the entire remaining unpaid principal balance as held for sale. The treatment under US GAAP and IFRS are a little bit different, but based on the current trend of transactions and the attrition within that portfolio, we would expect to have the remaining $10 billion to $11 billion of unpaid principal balances gone by the end of next year. And the majority of that is effected through market sales in tranches to the same group of buyers as we've been selling to for the last number of years very successfully. So I think we've got a good track record around this. Providing something utterly bizarre doesn't happen in the US, our level of confidence in terms of waving goodbye to the last of our US sub-prime assets in the next 12 months is pretty high. Then we would have the process of deregistering the Finance company from an SEC registration, and winding up and closing the various legal entities across the 50 states in which we've supported lending over the years.

On the UK mortgage market share ambition, there isn't one. We want to grow the business profitably, in a manner that's consistent with our risk appetite. So if you sat down and spoke to Francesca McDonagh and Antonio Simoes and said, 'Give me a share you'd be happy with,' they don't really have one out there. They're looking at it and saying, 'Look, as long as we can grow this business sustainably, profitably, within our risk appetite, then we're absolutely happy to continue to grow it.'

Alastair Ryan, Bank of America Merrill Lynch

Thank you for the language on net interest margin yesterday. A number would be great. Just on where that hits bottom, or if the margin's something that you're looking at, obviously if you're growing UK mortgages, that's presumably relatively low-margin nominal; it might be a good risk-adjusted return. But whether there's a floor to the net interest margin in the business today or whether that's going to require a different rate structure, which we may start seeing fairly soon from the Federal Reserve. The same thing, there's been some language – some discussion in the media about a more muscular HSBC in investment banking, which fills shareholders with a certain amount of dread, based on historical experience.

Iain Mackay

I think what Stuart said yesterday was he was happy to put capital to work where it is profitable and where it's generating a return above the cost of our equity. That's what he said, and that's what matters. And that could be Retail Bank, it could be Commercial Bank, or it could be Global Banking and Markets or Private Banking. To be clear, Samir Assaf, CFO GB&M has a challenge around assets in his business that doesn't return above our cost of equity, which has informed the fact that we continue to take risk-weighted assets out of that business. By the very same token, Robin Phillips, Matthew Westerman and Thierry Roland are out there looking at and deploying that churn back into assets that are profitable. That naturally, and quite appropriately, leads to interesting discussions with customers that have been getting a very good deal from the Bank for some time. So there is a long and distinguished list of customers that are getting visits from HSBC bankers, having a conversation about re-pricing business, and if we're unsuccessful in that re-pricing then lines will not be renewed when they come up for renewal.

Alastair Ryan

On the net interest margin, what is it and do you expect it to go up or down?

Iain Mackay

Net interest margin at the third quarter year-to-date at a Group level was 180 basis points, and that was a couple of basis points off from where it was at the second quarter. And the drivers of that was foreign currency translation impact of adverse four basis points. We had a pickup in terms of lower cost of funding in the UK, lower cost of funding in Mexico and Argentina, and Hong Kong, and a little bit of pressure from higher TLAC costs, as Richard O'Connor mentioned earlier.

Stephen Andrews, Deutsche Bank

Coming back to the capital return question. If we look at the legal subsidiaries, which are what have to pay the dividend up to the Group to pay the Group dividend, it strikes me that nothing's changed in HBAP, because that's already on the same BoCom treatment you've moved to, so over the next one or two years the most likely source of excess capital up to the Group, above and beyond normal dividend, is still North America. As you've pointed to the $3-4 billion coming out, of excess, out of North America Holdings, also potentially $3-4 billion from HSBC Finance if that's wound up.

On creation of the intermediate holding companies on 1 July for all the international banks, there's a tough threshold above the $250 billion balance sheet size. I think you would have been sat around $290-300 billion pre-windup of Household and others. Can you give us a bit of a flavour, if you do manage to get the balance sheet below $250 billion, how much easier do the capital requirements for you become, from a CCAR perspective? Do they gap down significantly? Is it worth considering that? Does that help the process of upstreaming trapped capital?

Iain Mackay

So, the application of the Fed's SR 15-18 and 15-19 under these Regulations, where one is you're at $250 billion or below, where there is this notion of a CCAR-lite, versus the alternative which I think is SR 15-18 or maybe it's 15-19, where if you're above $250 billion you've got the full force of a CCAR and DFAST assessment. Whether it necessarily means – so the process changes, so the amount of documentation, stress testing, modelling, that you have to do would seem to be less, but what that really means is not particularly well defined at this point. So it's a nice concept, but I think what we and probably others in a similar position need to think about is whether constraining your business to be at or below $250 billion, does that make the capital management equation, the cost that you have to invest in managing CCAR, running CCAR and all the stress testing, the documentation, the modelling, an incredible – let's not call it a bureaucracy, but a bureaucracy around that, does that merit constraining possibly the growth of your business to remain below that level? Because if you go above it, it would seem pretty clear it's a bit of a bright line, that you immediately fall back into full-blown CCAR.

It's also not clear that just having $250 billion necessarily puts you in that less-complex world, because there's language around the complexity of your operation. And when your operation is internationally focused, that's one of the criteria that one reasonably could assume the Federal Reserve would look at in terms of not reducing the amount of complexity in the capital management process. So, long answer, but the short answer is it's too early to say. Your numbers are in the right place. So as we get the remaining $10-11 billion of unpaid principal balances off over the next year, one, you're right, more capital will be released from that, so the amount of capital that we would no longer need to support our US businesses would become available – well, would be in our view viewed as surplus; it would become available for a dividend discussion with the Federal Reserve, as part of the normal annual CCAR process.

And then there is the wider question around the attractiveness of constraining your business and being able to demonstrate that it's a non-complex business and therefore significantly simplify the capital management requirements and processes in the United States, because it is absolutely fair to say the level of investment that is required by our US team to comply with CCAR is significant. And we are viewed and assessed exactly the same as JP Morgan, Bank of America Merrill Lynch, Wells Fargo in this world. By virtue of the fact that we have got a small balance sheet – a much smaller balance sheet – doesn't remove from us any of the obligations that those large banks have. So you can imagine the kind of strain that puts on the organisation.

I was in the US a few weeks ago, and that was one of the questions to the team: 'Let's think about this, and let's, as it becomes clearer evaluate what that opportunity is, if in fact it is an opportunity.'

Stephen Andrews

The costs-to-achieve in Q3 were pretty large. Where did that go? Can you just give us an idea of a breakdown in terms of where that was being spent? Because the total is $4-4.5 billion, but for $1 billion or so to come in one quarter was quite unusual. What was it that was ramped up from a spending perspective?

Iain Mackay

That was mostly within the operations area, in terms of significant simplification across some of the technology platforms, operational platforms. It went to redundancy costs, it went to facility closure and lease termination costs, and that goes across a number of the global platforms we are operating in. So broadly speaking, the examples we gave you on the page are the main areas that those costs-to-achieve were across. So two thirds of that was within our operations area, which covers all the technology platforms within the Bank, the big operating centres, call centres, customer service centres, collection centres. We also had a couple of hundred million dollars going through the businesses, a large portion of that in Retail Banking and Wealth Management as they invest in their customer-facing platforms, which is part of our Retail Bank Transformation Programme that John Flint and the team have got going. And then we had, again, some within the Finance function as we continued to transform that, and also within Risk and Financial Crime Risk. Those are the main areas, but the Operations and Technology area is the big area that was the third quarter spend.

Anil Agarwal, Morgan Stanley

On China, maybe I misheard, did you say that you think there's some excess capital in China; you are in discussion with CBRC?

Iain Mackay

There may be.

Anil Agarwal

Yes, but that's the one growth market. Why is there excess capital? If structurally that is a growth market, why do you think there's excess capital?

Iain Mackay

We've got the capacity to grow, but we probably have more capital than we need to grow. It's a question of quantum, right? Business also generates capital, quarter in, quarter out. Strongly profitable business in China.

Katherine Lei, JP Morgan

I just want to ask – because I cover China banks, I think Chinese regulators are quite concerned about capital outflow, so where we are trying to repatriate capital out of China, will that be something that we need to discuss with them?

Iain Mackay

That's what I said. Nothing happens here without a good discussion with your regulators.

Katherine Lei

The other thing is that China just allowed financial institutions to have wholly-owned foreign entities in China. I understand that you will only deploy capital when you can achieve certain ROE, but understanding that this is from zero to something, at an initial stage there won't be a good ROE on that business. But would you be able to, or would you consider to invest your capital into that business?

Iain Mackay

Into which business?

Katherine Lei

A wholly-owned foreign entity.

Iain Mackay

We already have one, called HSBC China, which is 100% owned by HSBC.

Katherine Lei

I think what they mean is the investment banking side.

Iain Mackay

So we have a licence application in place for a majority owned, not a 100% owned, but a majority owned Securities licence. So that is in process.

Katherine Lei

If you can get that licence in 2017, then maybe the capital repatriation pipeline will be different.

Iain Mackay

Perhaps, but not necessarily.

Anil Agarwal, Morgan Stanley

On BoCom, from a capital perspective, now that it has moved to an equity accounting methodology, so the equity accounted share of earnings, was it counting towards CET1 capital in the past, and not counting incrementally, so incrementally, the CET1 generation will be lower than what it used to be – at the Group level, not at the HBAP level, but at the group level. Right?

Iain Mackay

For regulatory capital purposes, yes.

Anil Agarwal

Because that's quite a bit, right? That's about $1.5 billion.

Iain Mackay

Well, no, the accounting does not change. The regulatory treatment changes. So going forward, there is an almost static deduction from Common Equity Tier 1 of about $5.6 billion, but from an accounting perspective we'll continue to accrete through the P&L, which will flow through the capital resources.

Anil Agarwal

But on capital, you will not get that equity accounted share of earnings, right?

Iain Mackay

Yes. We do

Anil Agarwal

When you are doing the capital calculation, the CET1 capital, we need to deduct that at a Group level, not at HBAP level. While it is coming through the P&L, it's not going to count towards capital CET1.

Tony Bloomfield, Chief Accounting Officer, Asia-Pacific

As you pick up your profits, it runs through your accounting. But your carrying value increases, so therefore your deduction or your RWAs increase. It goes in, and then out.

Anil Agarwal

And third point, just on margins, obviously there's pressure on various parts of the business. In the last five or six years, interest rate increases was like *Waiting for Godot*. Last year rates went up. This year Libor has gone up, and in spite of that the net interest margins at HSBC has gone down. Third quarter, Libor went up quite a bit. Now we are waiting for another rate hike, and if I look at Asia there's massive pressure on spreads. I mean, there's competition in this geography for sure. So if rates go up by 25 basis points, the pressure from a competition perspective etc., is behind us, and so you start seeing some –

Iain Mackay

I don't think that necessarily changes the competitive environment.

Anil Agarwal

But what I'm trying to say is, do you think that we will start seeing that in terms of positive momentum on NII, or will it just compensate for the competition? The thing is, if I go back four years, and I said, 'Rates will go up by 25 basis points,' NII also could have been different than what we are seeing. If rates go up by another 25 basis points, should we be excited about that, or it will just negate the competition we are seeing right now?

Iain Mackay

I think that will depend market by market. But there are markets where we have a stronger competitive position, and where the ability to see that change in the yield curve through to the bottom line is probably more robust. I think Hong Kong is probably one of those markets. Middle East and North Africa, certainly the Emirates and other parts of that region, are again areas where we compete very strongly, and we would expect to see some benefit coming through. But I think you're right. In some markets, that will manifest itself simply as another proportion of the margin, conceivably that could be competed away to some degree.

Manus Costello, Autonomous

Just to ask back on that accounting treatment of BoCom. With that deduction of $5.6 billion, now, am I right in thinking technically if you were to write down the carrying value of BoCom, that it would actually be capital neutral up to that $5.6 billion?

Iain Mackay

That's right. Up to that $5.6 billion it would be neutral.

Manus Costello

Right, and does that influence your way of thinking about the BoCom stake, at all, in terms of the value in use and the comments you made? Were you making some comments on the call about reassessing the value in use at the end of this year, or was that just a comment around business as usual?

Iain Mackay

That's business as usual. Tony Bloomfield and his team redo the value-in-use assessment every quarter, and we have now, for what, three years? So, at that point that we saw a sustained impairment between the carrying value and the market value, the standard requires you to go and assess the value in use on a longer-term cash flow, and we've talked about that before and there are lots of disclosures in the Annual Report and Accounts and Interim Report. And that's a reassessment that we will do every quarter and we will continue to do that. Even at that point, assuming, at some point in the future, we do incur an impairment, even when we impair, we will continue to do that value-in-use assessment, because it will inform whatever impairment would be reflected in the financial statements, to the extent market value continues to be below the carrying value at that time. So, that is an ongoing business-as-usual assessment that we do every quarter.

David Lock, Deutsche Bank

On capital, when you're talking to the PRA about your capital position, is it fair to say that the focus in that conversation is more around a $1 billion distributable-capital figure or is it more around a focus of a particular ratio? I ask because, of course, it's quite important, considering you're now at 13.9%, but equally the PRA must be fully aware that the risk to the capital hasn't actually changed from quarter to quarter at all, despite the ratio improvement.

Iain Mackay

I would say neither, actually. Much of our conversations with the PRA are around individual components of capital and the risk associated with those components of capital and, most recently, much of the conversation has been around the makeup of the individual capital guidance. And you'll have seen, this quarter, disclosure around an increase of 30 basis points – at least that which is picked up at Common Equity Tier 1 – of the Pillar 2A component. So, I actually can't recall, in the last 24 months, a conversation which specifically addressed the Common Equity Tier 1 ratio, but it was much more focused on the evolution of the ratio, informed by capital actions that we take on an ongoing basis: how robust our ICAAP process is and how we can continue to reinforce and improve that process, how we inform capital measurement across the different businesses in the Group, the capital generation of the different subsidiaries of the Group, and actions that we would then take in terms of managing individual subsidiaries. And, obviously, there are certain of those which the PRA is more interested in than others.

But I think what the PRA has been consistently clear about is that, provided we meet their regulatory-capital requirements, how we then deal with the surplus to that is, to a significant degree – not exclusively, because notwithstanding the fact we exceed their capital requirements, they still want us to ask permission to do anything, which you can certainly understand – but the guidance has been, 'Provided you exceed our capital requirements, then how you manage that surplus is largely at the discretion of management.' But latterly, the conversation has been very much about individual capital guidance.

David Lock

I guess, to come at it another way, when you set your 12-13% target, which, presumably, was part of the capital plan that you had with the PRA, was the change in treatment of BoCom part of that or is this something that's come more recently?

Iain Mackay

No. The analysis and the work that we did which informed the target-setting in June of 2015 did not explicitly include BoCom, but it would be fair to say that we have been in discussions with the PRA about the regulatory treatment of BoCom for a long time.

David Lock

I have a second one on costs: very good performance, actually, over the last year on costs. You're now at $7.2 billion, I think it is, is the new level you're at. The rebased target's also $7.2 billion, so should we assume, therefore, that really the underlying costs, adjusting for FX, business sales, whatever, that actually that kind of flat-lines into the end of 2017 the run-rate; and as part of that, is compliance spend moving around? Is it still going up or down?

Iain Mackay

Notwithstanding the fact that we've made good progress, we still have – and you see this in the analysis that we've provided – significant inflationary pressures. We see that intensifying in at least one key market for us – the UK – over the next 12 months where our expectation is not completely out of line with those of the Bank of England in terms of inflationary pressures in the UK; and it is a significant business with a significant cost base within it.

Another significant component is we are very focused as a Group in terms of doing everything that we need to do to satisfy the requirements of the Deferred Prosecution Agreement and put ourselves in as good a position as possible to have that expire as planned on its fifth anniversary, which would be December 2017.
Although a lot has been accomplished, there's still a great deal to do in terms of building real sustainability and delivering sustainable outcomes in terms of our propensity to on-board customers efficiently with good customer due diligence; understanding tax transparency; highly automated, but also very robust ability to transaction-screen across various sanctions listings, and so the transaction monitoring is a truly mind-boggling and gargantuan undertaking, and there are significant investments that have been made and will continue to be made between now and certainly the middle or third quarter of 2017 in making sure we are as best positioned as possible to meet those DPA requirements, and hopefully have the DPA lifted in December 2017. There is significant investment still required.

So that is slightly different to what we guided in 2015, where we expected that to peak in the later part of 2016 or the early part of 2017. There is really – we see that not peaking for another six to nine months after that.

David Lock

Just to be clear, if it peaks in six to nine months after that, that means Q4 will see a large step down?

Iain Mackay

Not a large step down, but we're seeing the rate of it – hopefully stop increasing. Not hopefully, we need to see it stop increasing.

Chintan Joshi, Mediobanca

If you look at your RWA reduction programme, 82% done; you touched on cost today with the question, kind of looking at the current run-rate, by Q4 next year. But if I still look at consensus, it's modelling about a 9% ROTE, giving you the benefit of your cost targets with some revenue growth. That's still below your target; that's probably closer to 8% ROE. What's next in terms of strategic front because the strategic plan is getting there? So how do we think about improved returns looking forward one of the years?

Iain Mackay

So I think one of the things that we referred to at the half-year, when we said, 'Look, we're not going to make that 10% return on equity target' was informed by the fact that one of the inputs to developing that plan in 2015 was an interest rate scenario which evaporated in front of our eyes over the succeeding six to nine months.

Frankly, without some progress in interest rates, achieving a 10% return on equity within a reasonable timeframe we think will prove very difficult. Obviously the actions which we are going to continue to take is – and not telling you anything new here – even when we get to the end of 2017 it is about driving sustainable cost productivity through the operations of the organisation month-in, month-out. So we've got to keep driving for more efficient, more robust operating processes, a lower-cost position for the Group across all the operating platforms and the businesses in which we operate. So that is a lever that we can control, continuing to take those capital management actions which try and manage the equity position of the Group as efficiently as possible. That we can control to some degree, but obviously a close coordination and agreement with our regulators in that respect is also required.

And, as we said in June, continuing to recycle risk-weighted assets into profitable business – the rate of growth that we see in many of the economies in which we're operating is still at pretty low levels, and the demand and appropriate risk appetite that really allows us to redeploy that capital is another of the factors that had us revisit the timing of accomplishing that 10%. You will recall the 2015 Investor Update, we had conversation about "how do you redeploy $150-180 billion worth of risk-weighted assets?' So the capital associated with those risk-weighted assets over that timeframe, within six months we've changed it from $110 to $150 billion and we've actually not been able to redeploy anywhere close to that at this point. And, again, that translates directly through to the revenue line and the bottom line in our financial equations. So continuing to pursue opportunities to deploying capital profitably will be a central part of what we do.

Chintan Joshi

You said in response to the CCAR question that it might take many years to get the excess capital out of the US. Can you clarify that in terms of timing, whatever your go-to ratio in the US is determined to be? By when can we expect most of that excess capital to be repatriated to the Group?

Iain Mackay

It will be a number of years. I think there are conditions other than just the efficient operating of our US business to be able to take that capital out. Our view is that we need to have removed the DPA. So again, there is a strong focus on meeting the requirements of the DPA, not just to have – so we've got that rubber stamp from the Department of Justice that we've moved everything in the right direction and have a strong focus on rebuilding the reputation of the firm in that regard, but also it is not an express condition precedent. Our own view is that the Federal Reserve is less likely to allow us to remove large amounts of capital surplus to requirement until we've demonstrated that the US business is not only on track from a profitability and capital generation perspective, but very much on track from a compliance perspective as well.

And then going beyond that, the notion that we could in a single leap extract $4 billion, $5 billion, $6 billion worth of capital from the US I think is simply not realistic in the current environment. So our expectation is that we would have to work it through the annual CCAR process. There's not a process by which you can do this more frequently than annually, so it's an annual capital plan. And so realistically we're talking about – your guess is probably as good as mine, but I think realistically a three to five-year period.

Chintan Joshi

And then following up on the US rate hike, you've now had a few quarters to digest the first rate hike. How much have you seen that benefit come through in revenues?

Iain Mackay

I think there was a point made here earlier that in some markets we've seen that on the top line, but have seen it competed away in margin. But, broadly speaking, what we have seen come through is a couple of hundred million dollars in terms of top-line revenues.

Chintan Joshi

Finally, just to understand the accounting. So last quarter we were talking about HSBC having a $10 billion surplus in the Group, above which you pay dividends. We didn't quite talk about what that surplus was. Does this accounting, or does this reg change, increase the surplus at the Group level? So do you have $8 billion more capital now at the Group level calculation in the surplus?

Iain Mackay

No, it increases the surplus in the Group, but not presently at the Group level – at the holding company level. It's slightly different.

Fahed Kunwar, Redburn

I just wanted to follow up on the margin point. So it went up by two basis points FX adjusted, but it sounds like a lot of that was cost of funds falling. Your loans to deposit ratio has been ticking up and it doesn't sound like that's going to change either. So how much more slack have you got in cutting those deposit rates to offset the asset price composition you talked about?

And I have a second question on IFRS 9, just where you are in terms of implementation, how that plays into the costs-to-achieve. Is that accounted for in the costs-to-achieve spend and the compliance spend you talked about earlier?

Iain Mackay

It is included within regulatory and compliance programmes for the spend in that respect.

We are full speed ahead on IFRS9 implementation. It is a complex standard to implement for any bank; one operating in 70 countries around the world certainly makes it slightly more interesting perhaps than we want. But it's full steam ahead. We're building models. We're doing an evaluation of the various complexities within the standard; multiple forward looking standard scenarios in terms of evaluating how you inform provisioning on a quarterly basis.

In terms of providing any insight as to what the initial impact or the ongoing impact may be, it's more likely to be into 2017 before we get into a numbers discussion around IFRS 9 with you. And certainly the costs of implementing it are included within those regulatory and compliance programmes.

And then your first question on margins: where we are on cost of funds is to a significant degree informed by the rate at which we attract deposits. And as you quite rightly point out, the asset deposit ratio has been moving somewhat in the wrong direction from our perspective. We'd like to be deploying that capital and lending more, but what we invariably find is that when there's a little bit of uncertainty in the market, the deposits tend to flow to us. That's true in the United Kingdom and it's true also in our Asian businesses, and that certainly was a feature of the third quarter again. And when you have that kind of deposit flow it does give you slightly more flexibility around the rate on those deposits.

Do we have a huge amount of flexibility? No, because deposit rates are at incredibly low levels in the majority of the banking operations that we've got around the world.

Thank you very much for your time.