HSBC

Transcript

Fixed Income Call
H1 Interim Results 2022

2 August 2022, 2.00pm BST

CARLO PELLERANI, GROUP TREASURER: I'll start by mentioning a couple of highlights from the results, then I'll do a quick update as usual on financial resources and then straight into Q&A. I will not be referring to any slides as I go through.

So three highlights from the results. First of all, 9.9% ROTE for the half-year, largely driven by higher NII and good cost control, more than offsetting higher ECL charge. Importantly, we are now expecting to improve our ROTE to above 12% in 2023, which is well ahead of our cost of capital. Second, in terms of balance sheet dynamics, $33 billion of adjusted loan growth in the half year, largely in mortgages and trade, alongside $24 billion growth in adjusted deposits. And lastly on the results, credit quality remains quite good. ECL charges equivalent to 21 basis points of gross loans for the half year, stage three loans stable at 1.8% of total loans and we are flagging that, despite the fact that our early warnings indicators are not yet showing any signs of stress, we have an expectation for ECL charge to normalise towards 30 basis points in 2022.

Onto financial resources - let's start with capital. Our CET1 ratio was 13.6%, which was down from 15.8 at the end of the year, the reduction mainly driven by timing differences in fair value OCI securities and some RWA growth. We remain 2.9 percent points above our MDA hurdle, although we are below our target operating range of 14% to 14.5%. We expect the CET1 ratio to trough in Q3, given headwinds that we have previously mentioned on the sale of our French retail business and some other M&A that is completing, and we expect strong earnings and management actions will help us lift the capital back into our target range during the first half of next year.

In terms of liquidity, it remains strong, most importantly at a legal entity level but also you can see that in the overall group LCR ratio of 134%, and we still have an HQLA on a gross level of about $800 billion. We have a loan-to-deposit ratio at 62%, which positions us quite well actually in the current rising rate environment. Our MREL ratio, 28.7%, compares favourably to a 26% requirement which, as you will see, is still the sum-of-the-parts calculation. We intend to continue to operate a prudent buffer of over $29 billion.

From a funding perspective now, we have made good progress this year in, let's call them, interesting markets. We have issued $8.4 billion of senior HoldCo and $2.6 billion of Tier 2. As you will have seen in our deck, we have increased our funding plan for the year by about $7 billion in senior HoldCo and $1 billion in Tier 2, which positions us halfway through the overall funding plan at this point. The reason for the increase in the funding plan is to offset negative market moves that we have impacted the liability value of our reg bonds, just to flag that that impact over time will unwind as those bonds are pull to par and, as a consequence of course, we are expecting that this will reduce funding needs in future years, all else equal. As mentioned at the full year, we continue to expect not to refinance any of AT1 calls that we may look to make in 2022.

I am pleased to just have announced, literally before this call, an exchange offer targeting some of our older legacy Tier 2 securities, issued by our holding company. You'll find an overview of the transaction that has been included in our updated fixed income deck on the website. The transaction is a par-for-par exchange offer, which is the most logical structure given the practical challenges that exist with consent solicitation under New York law, and we plan to use exchange accounting, which minimises the cost of the exercise for us. Having said that, we're also offering a 35-cent incentive payment in order to encourage everyone's participation.

Just to close on legacy capital, as I am sure there will be some more questions about it, I just want to remind everyone of our position on those. We are aligned with the Bank of England in our commitment to reducing the stack over time. However, doing so cannot come at any cost. We are willing to take some cost to exit those positions but, as we have flagged in the past, we have made some historical hedging and accounting decisions that make the economics of taking the full stack out in its entirety not currently feasible or rational. So we will continue to monitor the portfolio and if further opportunities arrive we will take them.

So, in summary, a strong half-year result with a clear path to solidly returning above cost of capital. Our financial resources of capital, funding and liquidity leave us all well placed to continue growing. Our business model continues to offer bondholders one of the most diverse sets of revenue streams in global banking. That's all I thought of saying, so I'll stop here and let's open out for Q&A. I'll hand over to Greg.

GREG CASE, HEAD OF FIXED INCOME INVESTOR RELATIONS: Thanks, Carlo. Yeah, hi everyone. So we'll be taking question over Zoom, so a little different to our previous setup. If you want to ask a question, you can use the 'raise your hand' function you'll see at the bottom of the screen, and we'll open up your line and, please, do make sure that when we do that you unmute. I think Zoom tends to leave you muted if you don't. There is also the Q&A function at the bottom if you'd like to ask one via text, but of course it would be great to speak to you in person if possible. So I'll just leave it a minute and let some of the questions come through.

Our first question comes from Dan David at Autonomous. Dan, your line's open.

DANIEL DAVID, AUTONOMOUS: Hi, Greg, Carlo and Richard. Thanks for doing the call and taking my questions. I've got a couple.

The first one is just on issuance plans for this year. So I hear you on no new AT1 issuance for potential refinancing this year. However, I guess I'm looking out to next year and I think you've got quite a heavy potential call schedule. So would you look to AT1 markets this year to potentially get ahead of your refinancing needs next year?

And then secondly, as expected, a few questions on legacy. So I'm yet to see the details of the exchange, but I welcome that and I hear your comments on the RAF and where we're headed. I'd just like to drill down on that a bit more and I realise you're probably limited in what you say. I'm just interested by what the PRA have told you, if they've given you targets to reduce by an amount per year. And then also, just on the reasonable economics point, does that – and I hear your comments on taking a small CET1 cost. Do you need to get back to your CET1 target range before you can take CET1 costs as a result of potential legacy calls or LMEs? And also if you can give us any guidance as to what is reasonable, that would be really interesting, thanks.

CARLO PELLERANI: Hi, Dan, thanks for your questions. So on AT1 first, this year was a transition year. You might remember that we mentioned that we were overweight in AT1s and underweight Tier 2s, so this year was rebalancing. With the actions that we're taking this year, that pretty much brings us in line. So going forward, it's all about maintenance and refinancing. And yes, to your point, it is always a possibility to try to pre-finance some of the potential call for next year, so that is something that we would leave open, market conditions dependant.

In terms of the legacy stack, no, we haven't had specific targets from the PRA or Bank of England about it. It has been just more a generic discussion. The way I would characterise it is that everyone would rather not have those securities outstanding because they're a little bit of a – it's a nuisance to have those securities outstanding from a resolvability perspective. And to give you some guidance in terms of cost, I guess the best I can do is to give you a sense of how I think about those securities. And the way I would describe them is there are two dimensions to the equation.

The first one is how challenging each of the securities are from a resolution perspective, and there is a pecking order of those securities. So I would call out that our securities from the holding companies are the ones that are the most complex from a resolution perspective, because they are issued from the holding company, they do not have the contractual recognition of the Bank of England bail-in powers, and hence they create this potential infection risk. So the way we are dealing with those is clearly with the exchange and then to voluntarily derecognise the remaining bonds from 2025. But then you go from that point on and the rest of the entities are still a challenge, but they're less problematic than the ones from Holdings.

And then you have the other dimension, which is the cost, and that dimension is driven by what is the accounting and hedging arrangement that we have on those bonds, whether they have significant optionality value and so on and so forth. So when you put those two dimensions together, you end up with a pecking order, which is broadly as follows. First is the holding company securities, then is the subsidiary securities that are fixed rate instruments, then you have the floating rate securities and maybe lastly you have the legacy tier 1 securities. So obviously we are announcing today an exchange for the holdings securities. We will continue to assess one-by-one the other securities to assess their economics, but that hopefully gives you a little bit of a guidance of how we are thinking about it.

DANIEL DAVID: Thanks for that. Can I just ask on the legacy Tier 1s coming bottom of the list, is that more because of cost rather than the problems they pose?

CARLO PELLERANI: Predominantly. I would also say that on those securities we are able to bail in the guarantee - so technically, bail-in is executable. There is some complexity, but it's executable. But yes, you can assume that, given that those securities have been outstanding for a while and we haven't called them, that the economics are not particularly attractive.

DANIEL DAVID: I've probably taken too much of your time but thank you for that. It was really helpful.

CARLO PELLERANI: Thanks.

GREG CASE: Thanks, Dan. Next question comes from Ellie Dann from Morgan Stanley. Ellie, your line's open.

ELLIE DAN, MORGAN STANLEY: Hi there, thanks for taking my question. My question's regarding the upcoming AT1 call. So that's the 5.25% callable in September of this year, which has not yet been pre-financed. Considering you've got no plans to issue AT1s this year, I was wondering what your thoughts are on this call. I know that you're well above your efficient level of AT1 in terms of MDA, in excess of about $4.8 billion, so my assumption would be that the supervisor would allow you to call those bonds if you wished without refinancing. I'd be interested to hear your thoughts.

CARLO PELLERANI: Yes, hi Ellie, thanks for the question. We have no impediment in calling that from a regulatory perspective to your point. We are as usual in the middle of the call period, so we will take advantage of that period. We haven't announced anything to date, but you shouldn't read anything into that. We will continue to assess and we will make an announcement when appropriate.

ELLIE DAN: Okay, thanks again.

GREG CASE: Great. Thanks, Ellie. We have got a few written questions in from Richard Thomas at Bank of America. Let me just read one out. So, Richard asks about the Ping An situation - people are asking a him about the potential for HSBC to be broken up. I was wondering if you could run through a summary of HSBC's current views?

CARLO PELLERANI: Richard O'Connor, why don't you take that? You are well versed after this week.

RICHARD O'CONNOR, GLOBAL HEAD OF INVESTOR RELATIONS: Yes, thanks, Carlo, and good afternoon everyone. Look, not much to add to – you saw the call yesterday morning. We continue to engage with all our shareholders on all proposals for enhancing shareholder value, and we made a number of announcements yesterday, which are intended to do that, including some very firm dividend return announcements, and we think that the strategy is definitely working.

We are not going to talk about individual shareholder discussions on any call, but I think we set out very clearly yesterday on the slides some of the issues which were leaked in the press. And at this stage, we don't see that there's value to those proposals versus the very clear, what you might call, plan A strategy to improve returns, improve dividends, improve capitalisation over the coming quarters and indeed years. So, we continue to engage with all shareholders. We had a further meeting today in Hong Kong with our retail shareholders and the same issues were discussed there as they were in the call yesterday. I don't think there's anything further, Richard, to discuss over and above what was discussed yesterday.

GREG CASE: Thanks, Richard. Another one from Richard Thomas before we move back to the phones. So probably one for you, Carlo, on legacy. Richard says that a few of his clients have pointed out to him that we changed our stance on legacies between year-end and now. Is that your sense of things? How do you think our messaging has evolved over the course of this year?

CARLO PELLERANI: No, I wouldn't say that we have changed our stance. It's pretty much the same that it was at that point, which is it is a combination, as we have said in the past, of what is the complexity from a resolvability perspective and a cost. So I would just say that we're just providing further clarity on that, pleased that we're making steps forward with the exchange announced today.

GREG CASE: Thanks, Carlo. Next question comes from Robert Smalley from UBS. Rob, your line is open. Please, go ahead.

ROBERT SMALLEY, UBS: Hi, thanks for taking my question and thanks for doing the call. On the call yesterday, it was mentioned that you did a study of potential impact of a downgrade and you thought it would be 25 to 50 basis points across the liability stack. Could you talk about what went into that and how you came to that conclusion? That's the first question.

Second, as you went over your review, MREL, Tier 2 etc, did anything else come out in terms of efficiency? Now that you've scrubbed down everything, should we look for any changes in your MPE strategy, funding strategy of the subsidiaries, etc.

And then third, with an increase in dividends, it's very clear that your equity holders enjoy a dividend and really a lot of them depend on a dividend from the stock, particularly retirees. Could you talk about any potential tension between increasing the dividend and the needs and desires of debt holders to ensure that their debt will continue to be covered, particularly as liability stack becomes more expensive. Thanks.

CARLO PELLERANI: Thanks for those questions, Rob. Maybe I'll ask Greg to cover that first question on the cost of that stack.

GREG CASE: Yeah, sure. Hi, Rob. So the analysis is effectively based around the fact that, if you take a hypothetical split of the group and you split the Asia business away from the rest of the group – let's call it RestofWorldCo. RestofWorldCo versus its peers, at its current rating, arguably isn't sustainable, you're arguably a notch or two lower than current ratings today when you look at the peer group. So when we look across not just the debt liabilities but also the broader funding base of that group that does currently benefit from that ratings premium, that's the kind of funding differential that we thought could filter through.

CARLO PELLERANI: So on your second question on efficiency, we have looked as deep as possible to the questions that were posed and the potential options. We haven't found opportunities for efficiencies. Naturally, when you hold a group together versus separating, there are some natural synergies and inefficiencies around it, and that's really what dominates the analysis that we described yesterday and that Richard just highlighted.

In terms of your third question on the trade-off of the reliance on dividends and the overall capital management, I think it was last year when we changed our capital policy. Historically we used to have a fixed dividend component, and what we have made now is a pay-out that is linked with the profitability of the group. So we think that that is a sensible way of balancing all of these requirements, so to the extent that the company is highly generative then our dividends will increase; to the extent that it isn't, they will decrease. So it creates like a natural stabiliser that we think is probably the best way of balancing all of that.

RICHARD O'CONNOR: And, Carlo, let me just add to that. Look, clearly, in the second half of the year we hopefully intend to get back within our 14% to 14.5% range. As Carlo said, the previous divided policy was a fixed policy which didn't really covering earnings and growth appropriately. We think this policy does do that and it does allow for – and if we can achieve our return target of 12%-plus, the group will be substantially cashflow-generative and there'll be a good policy to give dividends back, to fund growth but also to ensure that debtholders have a very healthy level of capitalisation and liquidity, and we fully commit to that today.

ROBERT SMALLEY: Thanks for the complete answer, and thanks for doing the call.

GREG CASE: Thanks for your questions, Rob. So the next question comes from the line of Robert Thomas from T Rowe Price. Rob, your line is open.

ROBERT THOMAS, T ROWE PRICE: Hi, thanks for taking my call, my question. I just had a question on how you're thinking about calls not just on Tier 2s but also part of your senior stack. I think, looking at the markets right now, there's a lot of extension risk priced in to even some of the senior MREL bonds, and I just wanted to see if you could walk us through how you assess determining economic value in those calls and if you were looking at possibly looking at letting those go out to maturity. How do you assess what the value of that extension would be? Is it simply part of your liquidity, then, or would you need to then replace it with MREL?

CARLO PELLERANI: Hi, Robert. Thanks for the question. For senior debt, the call period that we have is really, really short, so those calls are designed to optimise the treatment of those securities from an MREL perspective and to basically be able to reduce the balance sheet when it's no longer effective. So the intention for all those is to call them, right? For all the MREL transactions, that's the intention. Obviously it is not something that we would guarantee, but it is designed for it to be valuable for us to call them. So that's what I would say in terms of the seniors.

ROBERT THOMAS: Thank you. Thanks for that.

GREG CASE: Thanks, Rob. And we've got a question coming in from Phil – sorry, I've lost the button – from Phil Pühler at Deka. Phil, your line's open.

PHIL PÜHLER, DEKA: Yeah, hello, everyone - thanks for making the call and thanks for taking my questions. I've got two. First of all is on your China real estate exposure. You took some provisions this quarter, but do you think this will be sufficient for the long run? And the other point is in terms of issuing new senior bonds. Which currencies would you prefer at the moment? Do you just look at which currency would be cheapest or are there other factors playing a role as well? Thank you.

CARLO PELLERANI: Hi, Phil. Thanks for the questions. Richard, you want to cover China real estate, please?

RICHARD O'CONNOR: Yes, thanks. Again, we covered it yesterday, but I'll just add a few additional comments. But, as you know, that sector came under stress from the second half of last year and we've taken cumulatively around $900 million of provisions, on average $300 million in the first half of the year, about $150 million each quarter, as some medium-size developers go into stage three.

So it's fair to say that that sector's obviously going through some issues at the moment. However, the Chinese authorities are trying to stabilise the issue in terms of the developments and looking at a bail-out fund or a fund of that nature. Our sense is that we've taken the appropriate provisions at this stage. When you look into the second half, we do think that within our ECL guidance, which we gave yesterday, of towards 30 basis points for the full year '22, there were will be further charges from China CRE as that impairment issue matures, probably of the same nature we saw in the first half, $300 million or even slightly more. And, indeed, if a large developer gets into further issues, then clearly there may be $200 million or $300 million on top of that.

So we do think it's an issue that will be ongoing. We think it's very much controllable from a group perspective, given it's a relatively small part of the group's loans and advances. The offshore book is about $12 billion, really only about 1% of the group's loans and advances. I think the authorities in China are trying to stabilise the position, but clearly there will be, I think, further developments in the second half of the year, and that's really our guidance at this stage. Central case is for some further provisions of about the same magnitude in the first half or maybe slightly more.

We're watchful; we're managing the situation very carefully. And I think the Chinese authorities will resolve it, but I think it will take some time. I think this will take some time to resolve over the coming year or two, so I'm giving you some near-term guidance and let's see how we get on from there.

CARLO PELLERANI: And, Phil, for your second question, ideally we would try to match the issuance to our natural currencies because that avoids some of the volatility in the capital stack that you have seen in this quarter, for example. So we have about 50% of our RWAs are in dollars or pegged currencies. Then the next one down is sterling, which is about 17%, and then the remaining third is a combination of all the other currencies. That would be the dream treasurer's approach. However, unfortunately the market is not quite there. The market is predominantly a dollar market, so invariably what we try to do is we try to take pressure off the dollar market and try to diversify as much as possible, and we look largely at that in a currency-agnostic fashion. So we always are keen to try to diversify, so this year what we have done is we have done Swissies and Sing dollars in addition to euros and dollars. Last year we did CNH, Honkies and also Swissies, so we try to diversify away from dollars, but invariably, given the large funding pool in the US, we end up doing more in the US than proportionately we would want to.

GREG CASE: Thanks, Phil. Next question comes from the line of James Hyde at PGIM. James, your line's open.

JAMES HYDE, PGIM: Hi, I hope you can hear me.

CARLO PELLERANI: Hi, James.

JAMES HYDE: First question is I just want to have some more colour on the risk-weighted asset reduction measures for H2. I understand France, the closing of disposal, is one, but what others? Is it about continuing more collateral-taking? Is it more about offloading clients that don't meet ROE targets? I rather thought this was ongoing. I'm just wondering as to how you're going to accelerate this, which was the impression I got from the call.

Secondly, I see from at least the Bloomberg share register there are a few more Chinese institutions in there. And I just wondered if, beyond Ping An, have any Chinese institutions openly given support to current strategy? Thanks.

CARLO PELLERANI: Thanks, James. To your point, the RWA approach is one that is dynamic. We look at it all the time. Given the temporary depression, let's call it, that we have seen on the CET1 ratio, we have decided to accelerate some of those, and the focus is really on less profitable, less franchise clients alongside potentially some hedging opportunities that we have on some of the RWAs, so that is the bulk of the actions we are looking at at the moment.

In terms of the Chinese institutions, Richard, do you want to cover that?

RICHARD O'CONNOR: Hi, Jim. There's a limit to what I can say, because obviously the shareholder register – whilst it's public, obviously I'm not going to talk about individual shareholder positions; you wouldn't expect me to. What I'd observe is that clearly there's the Hong Kong-Shanghai Stock Connect, and you have daily data on that, and you can see that the vast majority of the position, when you look at the filings, is the Ping An position. It's not just Ping An. When you do the maths, there's a couple of other institutions there who've taken advantage of that stock connect to invest in Hong Kong and our Hong Kong stock, which we very much welcome.

But, more generally, when you go through the shareholder register on Bloomberg, then you will see a very large number of institutions in China and Asia on that register, and we very much welcome that. Clearly, we are dual-listed in both Hong Kong and the UK, and we're a key member of the Hang Seng Index, and therefore we welcome Asian institutions, including mainland China institutions and Hong Kong institutions, on our share register. And, indeed, part of the success of Hong Kong over the last few years has been the massive growth in the asset management industry in Hong Kong. There are well over 70 to 80 mainland China parent company asset managers now based in Hong Kong, investing in the city, investing internationally and investing in HSBC.

So, Jim, I wouldn't take it any more or less than that. It's something which we very much welcome. We welcome that internationalisation of the China asset management industry investing international and being part of our share register, so take it in that spirit, please.

JAMES HYDE: Okay. Thanks, Richard. Just another one for Carlo. I still am a bit surprised about the extent to which the market value of your liabilities affects MREL because, from an accounting perspective, a lot of it is amortised cost, so I just wondered is it currency more than anything else that's caused the stepped-up issuance rather than actual fair value or spread-related fair value?

CARLO PELLERANI: Yes, Jim. First of all the impact: the impact over the quarter was about $7 billion. About $4 billion of that was interest rates and about $3 billion of that was FX, so it was a combination of both.

It is a curiosity of MREL valuation, in which when hedging, regardless of the accounting treatment, from an MREL perspective, you fair-value it as a whole and regardless of the way you are hedging it as well, because the hedges that you may take from an interest rate perspective are not bail-in-able from an MREL perspective. So what you do is you determine how much capital you would be able to generate when you bail-in those securities, and that is the fair value at the moment. That's why it is exaggerated, and that's why perhaps it's larger than you may have thought.

JAMES HYDE: Thanks, Carlo. That's really instructive. I didn't realise that, thanks. That's it from me, thanks.

GREG CASE: Thanks, Jim. Just a quick opportunity for any last people to raise their hand for questions. I'll just give it another few seconds.

RICHARD O'CONNOR: Greg, we've got a chat Q&A on – does the 30-basis-point cost of risk guidance take into account the Chinese real estate bail out fund or is this pre that?

What I would say is that our guidance for 2022 is towards 30 basis points and, yes, it does take into account our central view on issues in the China real estate market, so just to cover that, which came in via Q&A.

GREG CASE: Thanks, Richard. And we've got another question for Olivier Doukhan from Citi. Olivier, your line is open… [Pause]. Okay, technical difficulties there, I think. I guess with that we're out of questions, so I'm back to Carlo.

CARLO PELLERANI: Yes, Richard and Greg, I was just asked to clarify my answer to the accounting treatment. Greg, why don't you have a go? Because I think I said more – perhaps I confused things a little bit more.

GREG CASE: So, look, Jim, on the bonds – if you do put a bond in an amortised cost relationship, if you put a hedge on it, then it's on a fair value hedge relationship, and what you do then is you'll fair-value the bond from an accounting perspective for rate moves. And, as you can imagine, when rates go up, the bond liability value goes down. That's reflected in MREL. From an accounting perspective, the swap liability, of course, goes up by the same amount so you don't get a CET1 capital benefit, but the swap, of course, isn't bail-in-able so it doesn't benefit your MREL, so that is effectively the mechanics.

CARLO PELLERANI: Okay, thank you. Thanks, everyone, for joining today. I hope the call was useful for all of you. If you have any further questions, please pick it up with Greg and the IR team, and you will see updated materials on the web with the information about the exchange. Thanks very much. Until next time.

GREG CASE: Thanks a lot.