HSBC

Transcript

Fixed Income Call
Q2 2021 Results

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CARLO PELLERANI, GROUP TREASURER: Hi, everyone. This is Carlo. I'm joined today by Richard O'Connor, our head of Investor Relations; and Greg Case, Head of Debt Investor Relations; together with Richard Boyns, Head of Capital Management.

I joined HSBC in March after about nine years at UBS. I know a few of you but I'm looking forward to meeting the rest of you hopefully in person soon in the future. In my first few months at HSBC, I have found the organisation to be full of opportunities. We have a tremendous franchise, and that is also true in the financial resources space, which is the bread and butter of what we do in Treasury. We have a very strong set of resources, and one of the key opportunities for us in the future is to look at how we optimise across all of these.

I'm sure you will have spent the last few days going through our results, so what I plan on doing today is just giving you a very high-level introduction, and then going straight to Q&A. I'm not going to refer to any of the slides. So today I'll speak a little bit about the quarter, our strategic delivery and our financial resources.

So first, on the quarter, as you saw, we generated a pre-tax profit of $5.1 billion for the quarter, $4 billion up year on year, and that included a release of $300 million of ECLs taking the year-to-date ECL release to $700 million. And as a reminder, we still retain about $2.4 billion of the ECLs we had built out during the post-COVID period.

Second, in terms of strategy, we are making very good progress across all the four priorities that Noel has set out, which as a reminder, were to focus, to digitise, to energise and to transition. You will see in the announcement from Monday's pages across all four, so we're very, very happy on how that is progressing. Alongside that, we are well on track to meet the financial resource commitments that we had made, including the reductions in cost and RWA.

In terms of financial resources, we have increased our loans by about 2% for the quarter, driven both by mortgages and higher trade finance balances, and our deposits have gone up by about 1% in the quarter. In terms of capital, we continue to have a very, very strong capital position. Our CET1 ratio is 15.6% – we have the declared an interim dividend of 7 cents per share for the first half of the year, and we remain very comfortably above MDA - by 4.7 percentage points.

In terms of liquidity, we also have a very, very strong liquidity position. We have about $850 billion of gross HQLA across the group. You will have seen that we have announced a technical adjustment in our calculation of our LCR that is takes the ratio down to 134%. The calculation adjustment reduces the ratio by about 10 percentage points and the methodology is intended to better capture transferability challenges of liquidity across the group, but just to stress that still represents a significant surplus of liquidity across the group. We have over $200 billion of surplus HQLA across the different entities of the group.

And finally, to talk about funding, in terms of AT1, you would have seen us in the market issuing about $2 billion of AT1 in year to date. We have also redeemed $2 billion, and this is in line with the guidance that we have provided in – broadly expect us to issue for refinancing. We have no additional plans for AT1 at the moment. Tier 1, likewise, we have very limited interest in that instrument for the moment, and you shouldn't expect us to be in the market anytime soon.

In the MREL space [senior holdco], our guidance for the year is $15 billion, as it was at the beginning of the year. You will have seen we issued about $7 billion during the last six months,

and you would have seen as well that we have started to venture in some of the locations that we haven't in the past. We had inaugural transactions in both HKD and in CNY. Diversification is something that we will deliberately continue to pursue, with the aim of trying to take a little of pressure off the most natural markets, in particular the USD markets. This issuance takes our MREL ratio to 30.6%, significantly above our 28% or so requirement that we have.

And finally, from an OpCo perspective, subsidiaries have very little funding needs, and OpCo issuances will continue to be relatively rare.

So just to wrap it up before we open for questions, we feel that this was another solid quarter: good earnings diversification across the group, and, perhaps more importantly, making very strategic progress on all our medium-term goals. On that note, we can open up for questions.

Q&A

LEE STREET, Citi: Hello. Good afternoon, all. Thank you very much for taking my questions. I've got a couple for you, please. Firstly, as the new treasurer, you talk about 'lots of opportunities'. Do you have any thoughts on what HSBC could do to make itself a bit more efficient, or what potentially might change or be different under your stewardship?

Secondly, Pillar 3 capital instruments disclosures – you've got quite a few instruments that only work as capital until June of 2025. Any thoughts on to what extent are they a serious impediment to resolution after June of '25, and are there any fixes to get around that?

And then finally, I suppose on a similar vein or similar theme, you've got quite a lot of operating company or HSBC Bank plc Tier 2 paper. I think I'm correct in stating that this obviously that won't work for MREL after this year-end, but still works as Tier 2 from a capital perspective, so any thoughts around how efficient that is for you as a form of capital instrument as one looks ahead? They would be my three questions. Thank you very much.

CARLO PELLERANI, HSBC: Thank you, Lee. So from an opportunities perspective, when you look across all the financial resources – capital, liquidity, funding, and also NII – what you can see is that historically, HSBC has had significant surpluses across all the metrics, so what we're trying to do is to make sure that the financial resources are fully deployed and aligned with our strategy, so we are putting a strong spotlight on each of the resources, and we are looking systematically at having too little resources or too much resources, and trying to have the best deployment for all of those.

I can give you an example if you are interested in each of those, but one that perhaps is most obvious is on the liquidity side. As I mentioned, we have $200 billion-plus of surplus liquidity across the group. A lot of that liquidity is not necessarily a bad thing. If you receive surplus deposits and those deposits are not costing you, it's not necessarily a bad thing, but then what happens is those deposits in some entities generate capital requirements. If those entities are leveraged constrained, in other entities you have MREL requirements that are also leverage requirements, so there is a cost to those deposits even if they price at zero, so what we're doing is we're putting a spotlight on all the resources. We're making sure that those operate adequately for each of the businesses and each of the clients that are providing them, and then we're trying to find the best way of aligning them to the strategy of the Group.

On your second question on let's call it 'legacy instruments and resolution' - this space is of course extremely complicated, and the way I would describe it is there are three dimensions that have to be taken into account simultaneously. One is the regulatory dimension. You would have seen, of course, comments by the Bank of England and PRA about it. We are in communication with them. Obviously, I cannot comment on this private discussion, but that is an ongoing communication. I would stress that this is not a space, from a regulatory perspective, that is black and white necessarily. Remember that, when those instruments were issued, they were fully compliant, and somehow their rules are changing, so that is a discussion we're having with a supervisor and a regulator.

Second, there is of course the practicality dimension. We need to see what is the practicality of potentially dealing with those instruments. The most challenging example perhaps is the New York law instruments where there isn't a magical solution that we have found for them.

So there are practical considerations that are perhaps challenging for us to affect change in those instruments.

And then finally are the economics of these transactions. Some of those economics are relatively easy for you from the outside to understand. Clearly, we have a fiduciary duty to our shareholders, and we will look to act economically over time, but some of the dynamics are a bit difficult to observe externally because, depending on whether we have or not hedged those instruments, whether, to the extent that we have hedges, those are hedge accounted or not, the economics for us internally may not necessarily be the ones that you're expecting externally. So long story short, you have a triangle with those three dimensions, and depending how these dimensions align, then what we will look to do. I can't comment on the discussions we're having with the supervisor and regulator. You will see us making a statement during June next year when this is public. We'll make a self-assessment on resolvability this coming October.

And on your third question, yes, I guess at the moment that an instrument stops qualifying from a regulatory perspective, and it changes, if you want, in the stack, then of course the economics of that instrument change, so to the extent that you had an instrument that was more junior, that drops from the stack, then you need to look at the pricing of that instrument in the context of replacement – more senior instrument, so that will be taken into account together with the practicality of potentially affecting that instrument in the market at all times.

LEE STREET, Citi: Okay. That's helpful, and just one quick follow-up there – you suggested the discussions with the PRA that are ongoing, they're private; I fully understand. Did you say the first that we would hear back would be June next year, or would you expect to, for example, in your Pillar 3 capital instruments disclosed at the year-end, to disclose the ultimate treatment – just because my understanding was this all needed to be wrapped up by the year-end when the grandfathering period ends, so what would be your best guess on when you first might be communicating back to us on all of this?

CARLO PELLERANI, HSBC: The official timeline is as follows. We need to make a self-assessment on our resolvability by 1 October, then that assessment is made public by both us and by the Bank of England in June next year. To the extent that it's something material in the interim according to our disclosure obligation, then of course we would make that public.

LEE STREET, Citi: Okay, that's very clear. I'll leave the floor for someone else. Thank you.

VIOLETA BARABOI, Societe Generale: Hi. Good afternoon, gentlemen. Thank you very much for having this call. Three questions on my side, if I may – the first one would be the China-Hong Kong political situation. Has there been any commercial impact? We haven't heard anything about it on the equity call, and there have been things in the press about state-owned companies reducing activity with HSBC, if you could give us a bit of colour on that.

Then the second question is about your NPL ratio. So currently, we have it at 1.8% in Stage 3 and it's unchanged this year to date. Do we think that they've already peaked, and if not, when do you think that this ratio might peak, and how far are we away from that peak currently?

And then the third question is about Stage 2 NPLs. They're still quite elevated at 15% of the book, and we've seen with other banks that most of them have seen reductions in Stage 2, and for some, that there have been significant reductions. Therefore, the question is: are we going to slowly track back to '19 levels, at around 7% to 8%, or do we think it's going to stay elevated for a while? Yeah, that's it on my side. Thank you very much.

RICHARD O'CONNOR, HSBC: Thanks, Violeta. It's Richard O'Connor here. I'll start with all three and let Carlo chip in. On the first one, the China-Hong Kong situation, clearly nothing much to say. You've seen the Hong Kong and China results for the last 12, 18 months. They've been highly respectable. We've at least maintained market share, had yet another good mortgage performance based on credit performance, and we're taking market share in Hong Kong.

Ditto in Mainland China: good growth in the book there, heavy investments in the wealth business is showing early signs of bearing fruit. We're not going to comment on any individual

one of them, be them state-owned or other, but we're on a very good pipeline of deals and transactions, including from the government on bond issuance in China.

We've also won licences, a fintech licence, the first foreign fintech licence – and we're looking to expand particularly that wealth franchise, as we said, into five more cities. So results are very solid, customer engagement very strong, very resilient results, and economically you can see that Hong Kong and China continue to perform well, despite some challenges from Covid that we've seen in the last week in China, unfortunately, and hopefully that situation improves.

So yeah, we continue to invest heavily, and the business continues to perform well. We obviously want to perform even better. That's why we're investing more heavily in the business, and those investments are showing good signs of traction. We strive for very good relationships with the regulating governments at all levels in China and have very good engagement with them.

On the 1.8% Stage 3, I'll give you two contradictory answers. You saw that the Stage 3 charges in Q2 were very, very low. In fact, they were zero of that $400 million recovery. We don't think you should expect that every quarter, as we said to the equity analysts. You do sometimes get a bit of bumpiness in our Stage 3 charges, and indeed our Stage 3 balances, but with that, obviously, seeing that Stage 3 NPL being broadly stable, and ultimately not a lot in the pipeline. So with the comment that it can be volatile, we're hopeful that as economies improve, and over the next 12, 18 months, you do see those Stage 3 balances come down, again with the proviso that, at the early stage of the economic cycle, sometimes you get some late-stage impairments as economies start to come out of difficult economic situations.

I'll just give you one example. Obviously, in the UK, we're seeing people coming off furlough. Companies are starting to pay down effective government debt, so there's still some incentives out there, but generally you're seeing Stage 3 NPLs very stable, and we're hoping they can touch down from what's already a very respectable level over the coming courses.

I'll just correct your names on Stage 2. It's not Stage 2 NPLs; it's Stage 2 balances which, as you say, are quite high at 15% of the book. They did come down slightly in Q2, and again, we would expect that to continue if, as we all expect, the economies recover over the coming quarters. It's difficult to compare banks on a like-for-like basis because we certainly do quite a lot of overlays when we look at Stage 2 balances, so I personally wouldn't compare each bank by bank. Look at the trends. Look at the commentary. Look at the overall condition of the book, and the condition of our book is good. It's been very, very solid through the last 12, 18 months, and we expect that to continue, and net-net would expect the Stage 2 overlays to reduce, but each bank has a slightly different methodology, and we think our Stage 2 overlays to get to that 15% are higher than some of our peer banks.

VIOLETA BARABOI, Societe Generale: Understood. Thank you very much.

CORINNE CUNNINGHAM, Autonomous: Afternoon, everyone. Just a quick one from me on MREL: do you think the CRR leverage requirement is going to drop out of your requirements? Do you think it's going to stop being a binding requirement, with a focus more on RWAs? I've seen that with a couple of other significant UK banks. I just wondered if that was happening the same with yourselves. Thank you.

CARLO PELLERANI, HSBC: Hi. Thanks for the question, Corinne. So the MREL requirements for us, as you saw, is the most binding of three dimensions: the RWA, the leverage requirements, or the sum of the parts. At the moment, and for the foreseeable future, we see both the leverage requirements and the sum of the parts being equally binding. If you decompose the sum of the parts into its components, then you will see that, in each of the different resolution groups, leverage is also one of the important drivers so, even if you get to a position where leverage in aggregate didn't become binding, it might be binding in the sum of the parts, bottom-up calculation. So you almost need to do the calculation bottom up and then try to figure out what it is.

Of course, when you are at the margin of where we are, the sum of the parts or leverage is the most binding, then perhaps there is a little bit of stickiness to the calculation. As we said, we're guiding that the current requirement is about, in RWA terms, around 28%.

CORINNE CUNNINGHAM, Autonomous: Thank you. And given that you issue all your MREL from the holding company anyway, would it just be easier to become single point of entry, or are there other technical reasons why you stick with the multiple point of entry?

CARLO PELLERANI, HSBC: Well, "easier to become single point of entry" depends on what you mean by easy, so let me step back. We like to call ourselves an 'MPE-plus' group. What that basically means is that the group issues MRELs top down and distributes to the entity, but the fact that we have three resolution groups – at least in theory, that could be advantageous from a resolution perspective, because it gives our supervisors an optionality that perhaps other groups do not have, and the optionality is to either hold the group together or to resolve it as three separate groups. At least at the beginning, in that hypothetical resolution scenario that ensues, holding the groups together has a big advantage because you preserve value, you avoid chaos, it's better from a systemic perspective and from a market-wide perspective, and then it buys you time to allow you to extract the most value to the group and to minimise the impact that it may have into the system.

Then in terms of – if that is the target point, then the question is, what is the advantage or disadvantage in going either SPE or purely MPE, if any? And then do remember that there are a lot of parties involved in this discussion, their interests in each of the different regions, so at the moment, we have a situation where potentially everyone has the best possible solution because there is optionality. Obviously, we continuously we review this together with the colleagues or supervisors, but as I said, at the moment, we are an MPE-plus for the reasons that I mentioned.

CORINNE CUNNINGHAM, Autonomous: Thanks very much.

TOM JENKINS, Jefferies: Good afternoon, chaps. Good afternoon, everybody. I've got one question. As usual, Lee and Corinne have nicked my best questions, unfortunately, obviously trigger happy on 'star 1', but there was one I still had, which was you've obviously, in the process of divesting some chunks of business in France and the US – obviously not the equity of the entities, more the assets, or the branches, or whatever you want to call it. There is debt left in those entities that either looks redundant from a regulatory perspective or expensive from a capital utility perspective. I was just wondering, is there – I'll leave it open-ended. What's your thinking on those debts?

CARLO PELLERANI: In terms of disposal, obviously, what we do is we look at the balances that are being transferred and the resourcing effect, right, so you just need to look at what is being transferred. So in the case of the US, we are disposing about $3 billion of loans and about $10 billion of deposits with $1.8 billion of RWA. So from a specifics, that means that basically, all else equal, there is an $8 billion funding gap that needs to be compensated for. It's not exactly that because there are surpluses and the requirements are different, but that is high-level the way to look at it.

In the case of France, it's actually quite balanced. Customer lending is $25.5 billion and deposits $22.4 billion, so the way it happens is you look at what is being transferred. You look at the resulting effects on all the financial resources plus also on the economics of your natural hedging that you had in place, and then you rebalance, but there isn't anything meaningful coming out of both of them. There isn't anything significant from a debtholder perspective to mention. The only thing I would point out – that it would be our intention to try to move the covered bond programmes to the buyers in France. That requires consent of the bondholders, but except for that, it should not be a major issue from a liability perspective. I don't know, Richard, if there is anything else you want to say.

RICHARD BOYNS, HSBC: No. I would just say, Tom, you need to look at what's left. We will retain substantial Wholesale businesses in both and in the US a medium-sized highly connected Wealth business, which will still hold the majority of the deposits by value because they are obviously the higher-value customers.

So I think you need to look at it in the context of the entity or entities concerned and the fact is a) it's good news that we are exiting these mass retail operations, but we're not exiting France or the US – remain substantial economies. We invest heavily in both. There is very strong connectivity with the rest of the group based on multinational business, Wholesale and Markets business in both, obviously Paris being the centre of our Eurozone activities and the US being

the biggest capital market in the world. So I think you need to look at it in the context of return for balance sheet in both and, as Carlo said, these are not meaningful transactions from just a pure balance sheet, loan, deposit, RWA business, but they were meaningful in terms of the profit and loss of both entities. So I would look at it from a P&L and return perspective rather than a funding perspective, although clearly you need to look at both.

TOM JENKINS, Jefferies: No, in that case, Richard and Carlo, thank you. If that's the case, then one – if you're looking at it from a P&L perspective – and again, I do not know how you hedged or hedge against various bonds, but if I'm looking at – whatever – a 75-year, 80-year bond that I've got to pay 7% and change on for almost minimal capital, I'm just wondering what the purpose of that would be in the US, for example – just for example.

CARLO PELLERANI, HSBC: Sure. I guess the only other main thing to think about is, of course, the value of focus in the strategy, so obviously focusing on our strengths and trying to avoid a dilution of management in areas that are perhaps less in line with our strategy. There is an additional value, but yeah, the point you make is a valid one. We look at that and, of course, as we rebalance, we take it into account.

RICHARD BOYNS, HSBC: Yeah. I'll repeat what Carlo said about looking at our capital securities, including legacy capital securities – those comments remain valid here as much as anywhere else.

TOM JENKINS, Jefferies: Chaps, thanks very, very much indeed.

RICHARD O'CONNOR, HSBC: Thanks, Tom. Thank you.

TOM JENKINS, Jefferies: Have a lovely afternoon.

ALVARO RUIZ, Morgan Stanley: Hello, guys. Thank you very much for taking my call. And I have a very specific question and it's about the disclosures issued from the Hong Kong bank. As per your Pillar 3 the Disco is not eligible anymore after January and reading all your disclosures this bank has very high liquidity. I just wanted to have some sense about the economics about not redeeming this security. The more information, the better, but I know that you cannot disclose that much. Thank you very much.

CARLO PELLERANI, HSBC: Hi, Alvaro. Thanks for the question. You answer the question for me. We cannot quite discuss specific bonds. So what are the things that I could say that are helpful? I think the first thing is just to restate what you said – if the security locally doesn't have regulatory eligibility, so, of course, going back to what I was saying earlier, the economics of the security has to be assessed against the replacement cost of a more senior note and hence a cheaper note.

Having said that, the spreads on those securities are relatively cheap. It gives you long-term optionality. So the way to think about it is, to the point you're making, you assess the surplus liquidity you have, you assess what are the additional expectations you have, in time you try to project that, and then you decide whether there is any need for this security or indeed there is a value in keeping it. I'm afraid that's all I can say, but I think from your question, I think the components that you're raising are the right ones to consider.

ALVARO RUIZ, Morgan Stanley: And just to confirm, you look at this security independent from the other securities issued out of the non-ringfenced bank.

CARLO PELLERANI, HSBC: Broadly, yes, we look at each of the entities. So MREL is pulled down from the top by the entity. So the entity will have a requirement and that requirement triggers a demand from the holding company and the company will pull it down, so you start at the entity and the requirement for the entity to evaluate the need and the economics, indeed.

ALVARO RUIZ, Morgan Stanley: Okay. And if these securities are not MREL-eligible, then if they are pure funding, are you just comparing with the costs of deposits, or am I missing something?

CARLO PELLERANI, HSBC: No, those are the right components.

ALVARO RUIZ, Morgan Stanley: Okay. Thank you very much.

CARLO PELLERANI, HSBC: Well, thank you very much for joining. Hopefully this Q&A was useful. If you have any more questions, please reach out to Greg, Richard and the IR team, and hopefully everyone will have a good end of the summer. Thanks very much.