Transcript

Q2 2017 Earnings Release

Conference Call with Analysts and Investors hosted by Douglas Flint, Group Chairman

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Corporate participants:
Douglas Flint, Group Chairman
Stuart Gulliver, Group Chief Executive
Iain Mackay, Group Finance Director

HSBC

Douglas Flint, Group Chairman

Good morning from London, good afternoon to everyone in Hong Kong, and welcome to our 2017 HSBC interim results call. Joining me today are Stuart Gulliver, Group Chief Executive, and Iain Mackay, Group Finance Director.

I would like to start with a word on behalf of the Board. This is a strong set of results across our major businesses and geographies, which adds further evidence of the successful repositioning of the firm since 2011. The benefits of diversification, combined with the Group's capital and funding strength, were once again apparent in the first half of the year. It is particularly pleasing that much of the improvement in both revenue and cost performance derived from management actions to reshape the Group around its core strengths. Management has continued to make good progress against the strategic actions laid out in June 2015, and a number of important milestones were reached in the first half, particularly relating to our business in mainland China and the new ring-fenced bank in the UK. It is increasingly clear that these strategic actions, and the transformation that preceded them, have succeeded in creating a solid foundation with attractive optionality for the future. They have also enabled strong capital return to shareholders through dividends and share buy-backs. I'll now hand over to Stuart to provide some context around the results, before Iain takes a more detailed look at performance.

Stuart Gulliver, Group Chief Executive

Thanks, Douglas. We have had an excellent first half of 2017, reflecting the changes we have made since our Investor Update in 2015 and the strength of our competitive position. We grew profit before tax on both a reported and an adjusted basis, as our three main global businesses maintained their strong momentum from the end of 2016. We also achieved positive jaws in the first half of the year.

Retail Banking and Wealth Management performed well, with strong revenue increases from increased deposits (particularly in Hong Kong), improving customer investment appetite, strong wealth management product sales across all categories, and the impact of market movements within our life insurance manufacturing businesses. Global Banking and Markets continued to demonstrate the benefits of its differentiated business model, with revenue increases in the majority of businesses, particularly FICC, Equities, and Global Banking. Commercial Banking grew revenue on the back of strong growth in Global Liquidity and Cash Management, while Global Trade and Receivables Finance revenue began to stabilise after a difficult 2016.

Adjusted operating expenses rose slightly, as we invested more in business growth and made provision for more performance-related compensation in line with increases in profit before tax. We remain on track to hit our revised cost-saving target by the end of 2017. Loan impairment charges were lower than the first half of 2016, mainly due to improved credit conditions in the oil and gas industry in North America.

Our common equity tier one ratio was 14.7% at 30 June, up 260 basis points on the same point last year. Where we have excess capital, we are open to returning it to shareholders. To that end, and having received the appropriate regulatory clearances, we will execute a further share buy-back of up to $2 billion in the second half of 2017, which will commence shortly. This will bring the total value of shares repurchased since August 2016 to $5.5 billion.

We received regulatory approval in June to establish HSBC Qianhai Securities, which will be the first joint-venture securities company in mainland China to be majority-owned by a non-mainland Chinese bank. We expect the new business to launch in December 2017, pending the granting of the necessary securities licences.

We removed a further $900 million of costs from the business in the first six months of the year, taking the total annualised cost savings achieved since 2015 to $4.7 billion. Targeted initiatives removed a further $29 billion of RWAs from the business in the first half of 2017. Our RWA-reduction programmes have extracted a total of $296 billion of RWAs from the business since the start of 2015, comfortably exceeding our target. Finally, the US business received a non-objection to its capital plan from the US Federal Reserve Board as part of CCAR in June.

Iain will now talk you through the numbers.

Iain Mackay, Group Finance Director

Thanks, Stuart. A quick look at some key metrics for the first half: on an adjusted basis, we have positive jaws of 0.5%; the reported return on average ordinary shareholders' equity was 8.8%; the reported return on average tangible equity was 9.9%; and we had tangible net asset per ordinary share of $7.26.

Slide 4 provides detail on the items that take us from the reported to adjusted for both the second quarter and the first half. Last year's reported results include fair value gains on the credit spread component of our own debt, which we refer to as FVOD. You'll recall this changed as of last quarter. These movements are now reported in other comprehensive income, following the adoption of IFRS 9 rules relating to presentation of these instruments. That means that the income statement for the first half includes no gains or losses relating to FVOD, whereas the comparable period in 2016 included a positive fair-value movement of $1.2 billion.

The reported results for this year's first half also include $1.7 billion of investment to achieve our target cost savings, compared to $1 billion in the same period last year. You'll find more details of these adjustments in the appendix. The remainder of the presentation focuses on adjusted numbers.

Slide 5 breaks down adjusted profits at the first half of 2017 by global business and geography. Adjusted profit before tax of $12 billion was up $1.3 billion or 12%, driven by higher revenue and lower loan impairment charges. We achieved positive jaws of 0.5% in the first half of the year.

There's a detailed note on the accounting for our stake in Bank of Communications of page 94 of the Interim report. The headroom between our value-in-use calculation and the book value in the account has increased by $100 million to $400 million in the first half of 2017.

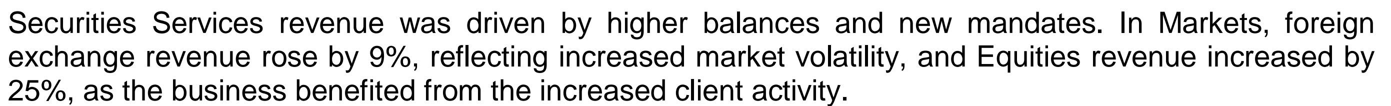
Slide 6 looks at profit before tax for the second quarter, which was $670 million or 13% higher than the same period last year. Profit before tax was significantly higher in all three main global businesses and up in all five regions. The increase in Europe was driven by strong increases in revenue in Global Banking and Markets in the UK and France, and lower loan impairment charges in commercial banking. The increase in North America was driven by a reduction in loan impairment charges in the US and Canada, particularly in the oil and gas, and mining, sectors. We achieved positive jaws of 1.6% in the second quarter.

Slide 7 provides more detail on revenue. Our global businesses maintained their strong momentum from recent quarters, growing revenue by $729 million or 6% compared with last year's second quarter. I'll go through each business in more detail over the next few slides.

Slide 8 looks at Retail Banking and Wealth Management, which grew revenue by 9% compared with last year's second quarter. Wider margins and higher balances in Hong Kong helped increase revenue from current accounts, savings and deposits by $235 million. Income from investment distribution increased by $73 million from higher sales, reflecting the impact of renewed investor confidence. Life insurance manufacturing revenue increased by $159 million, reflecting positive market impacts in Asia. And we grew customer deposits and customer lending by 7% and 5% relative to last year's second quarter, following strong performances in Hong Kong, the UK and Mexico.

Revenue in Commercial Banking grew by 1% compared with last year's second quarter. Global Liquidity & Cash Management had a strong quarter, growing revenue by 11% through wider margins and balance sheet growth in Asia. Credit & Lending revenue was broadly stable, as balance sheet growth in Asia compensated for the impact of margin compression. Global Trade & Receivables Finance revenue was down slightly compared with last year's second quarter following repositioning of the business in MENA, but stable relative to this year's first quarter. Loan Impairment Charges were $146 million lower than the same period last year, mainly due to lower charges in the oil and gas sector.

Slide 10 looks at Global Banking and Markets, which grew revenue by 7% compared to last year's second quarter. Global Banking and Transaction Banking products did well in the quarter, demonstrating again the benefits of our differentiated business model. Global Banking revenue grew by 16%, aided by increased recoveries relating to restructured facilities and investment banking fees. Higher balances in Global Liquidity and Cash Management helped deliver a 15% revenue increase, while a 13% increase in



Securities Services revenue was driven by higher balances and new mandates. In Markets, foreign exchange revenue rose by 9%, reflecting increased market volatility, and Equities revenue increased by 25%, as the business benefited from the increased client activity.

Slower fixed-income trading across the industry reduced revenue from Rates and Credit, which fell by 22% and 27% respectively. Overall, FICC revenue fell by 11% compared to last year's second quarter. We added high-returning risk-weighted assets to the business in the second quarter, but we expect model changes to deliver around $20 billion of RWA-savings in future quarters.

Slide 11 shows the impact of Global Banking and Markets' business model and what makes it different. We have clear bias in our product mix towards products that generate stable and recurring revenue. That derives in part from our client mix, which is more evenly balanced between financial institutions and corporates than the industry norm. This has helped us to achieve the mid-single-digit compound growth that we promised in June 2015, at the same time as reducing risk-weighted assets in Global Banking and Markets by $107 billion since the start of our reduction programme. At the end of the first half, the business delivered a return on risk-weighted assets of 2.3%.

Global Private Banking revenue was lower relative to last year's second quarter, reflecting the impact of repositioning in 2016. However, it has now delivered two second quarters of revenue growth, with new business more than compensating for the impact of client and market exits. We had positive inflows of net new money in the first half in markets that we're targeting for growth, particularly Hong Kong. 66% of these inflows came from clients referred to Private Banking from our other global businesses.

Corporate Centre revenue fell by $183 million or 24% compared to the second quarter of 2016. The biggest driver was a $134 million reduction in revenue from our run-off US CML portfolio, as we continued to wind down the business. We completed asset sales of $5.5 billion in the first half of the year and US CML balances now stand at $1.6 billion. We expect to complete the run-off before the end of 2017.

Slide 14 looks at net interest margin, which was 1.64% in the first half. We are now seeing a stable net interest margin and higher net interest income as loan balances increase, particularly in Asia. We continue to have deposit surplus of around $400 billion and are well positioned for net interest income to grow as rates move higher. There's a detailed slide on net interest margin in the appendix, with more information on loan and deposit structures and HIBOR and US dollar LIBOR trends.

Slide 15 looks at operating expenses. We delivered positive jaws in the first half of the year and are continuing to focus on delivering positive jaws for the full year. Second-quarter costs were $7.4 billion or 3% higher than the same period last year, as our cost savings helped to support growth, and absorbed most of the cost of inflation and continued investment in regulatory and compliance programmes. Performance-related compensation also rose, in line with increases in profit before tax. We decided to accelerate investment in business growth in the second quarter, primarily in retail banking and insurance. This is to be funded primarily by unplanned gains from the sale of shares in Visa Inc in the US. We invested some of these proceeds in the second quarter, which contributed to the increase in costs. However, the main portion will be invested in the second half of the year. We have achieved annualised cost savings of around $400 million in the second quarter, which brings annualised inception-to-date savings to around $4.7 billion. We remain on track to hit our targeted annualised cost savings of around $6 billion by the end of the year and expect to invest $1 billion of costs-to-achieve in the second half of 2017.

Moving on to slide 16, loan impairment charges were $427 million in the second quarter or 19 basis points as an annualised percentage of gross loans. Reduction in loan impairment charges, compared to last year's second quarter, was mainly in North America. This reflected improved credit conditions, primarily in the oil and gas sector, while last year's second quarter also included a single significant change on a mining-related corporate exposure. Our credit standards remain robust and the credit outlook within our portfolio remains stable.

Moving to capital on slide 17, the Group's common equity tier 1 ratio was 14.7% on 30 June, compared to 14.3% on 31 March. Our common equity tier 1 capital increased by $6.5 billion, of which $2.8 billion came from profits net of dividends and scrip; $2.1 billion came from foreign currency translation

differences; and $1.6 billion came as a result of lower deductions from capital. Today's buyback announcement reduces the common equity tier 1 ratio to around 14.5%.

Slide 18 looks at our Group return metrics. The return in average ordinary shareholders' equity was 8.8% and the return on tangible shareholders' equity was 9.9%. You can see from the slide that the impact of significant items in the bank levy was to reduce returns by 1.6%. I'll now hand back to Stuart.

Stuart Gulliver

Thanks, Iain. It's now more than two years since we announced our strategic actions, so I'm going to spend some time recapping some of the things we've achieved since then and, most importantly, the way they've improved the business. We'll start though with slide 19, which provides the usual update on our achievements in the first half of the year. There are four main things from this slide that I want to note and I'll cover the others in the slides that follow.

The first concerns the UK ring-fenced bank, which was granted a restricted banking licence from the FCA and the PRA in July. This is a major step towards establishing HSBC UK and it keeps us on course to complete the process in 2018. We made good progress in establishing the HSBC UK IT infrastructure in the first half, and have now moved around 170,000 customer sterling accounts to new HSBC UK sort codes. We expect to move the remaining sterling accounts that require new sort codes by the end of September. We are very well advanced in filling the roles that will move from London to Birmingham, and remain on track to have a fully functioning team in place for the opening of the new HSBC UK headquarters in the first quarter of 2018.

The second point concerns our NAFTA businesses, all three of which increased profitability in the first half of the year. Mexico contributed another strong performance, growing revenue and capturing market share, particularly in retail banking. Both the US and Canadian businesses grew profits on the back of significantly lower loan impairment charges. We continued to make very good progress winding down the US CML-legacy portfolio.

The third point concerns the work we've done to deliver above-GDP revenue growth from our international network. We have now upgraded this action to "on track". Stronger links between our network and businesses are having a lasting impact on our ability to increase international revenue, as demonstrated by a 17% increase in revenue from business synergies in the first half of the year. By building better links both within and between businesses, we've also increased the strength of our transaction banking franchise, which I shall return to shortly.

The fourth point concerns Global Standards, which you will see now has an amber check mark next to it on the slide. This is to provide clarity about what HSBC controls and what it does not control. We remain on track to meet all of the 2017 performance metrics we have set out for global standards – which is how we measure implementation. This has resulted in a dramatically improved ability to manage financial crime risk. At the same time though, we do not have certainty about what will happen with our DPA, which is within the discretion of the Department of Justice as described in detail in the Annual Report and Accounts.

We remain on course to complete the majority of our strategic actions by the end of 2017.

Slide 20 illustrates the progress we've made since 2015 on increasing efficiency across the business, both in terms of capital and costs. Our risk-weighted asset reduction programmes have now removed a total of $296 billion of risk-weighted assets from the business since the start of 2015, comfortably exceeding our target for the end of 2017. The reduction in risk-weighted assets has helped us build one of the strongest common equity tier one ratios in the industry, allowing us to maintain a strong dividend, return $3.5 billion to investors in the form of share buy-backs, and to announce a further $2 billion share buy-back today. We have also now taken $4.7 billion of annualised costs out of the business by investing in better, safer and more efficient systems and processes, as Iain has already said.

Slide 21 shows the impact of the work we've done to increase our international connectivity. 49% of Group client revenue is now linked to our international network, up from 45% at the same point in 2016. By investing in the capabilities of our network, we've also been able to increase the value of Transaction Banking products to the group. Transaction Banking product revenues are fundamentally international in

nature, command high margins and tend to be 'sticky' once acquired. We have continued to grow the proportion of Group revenue provided by transaction banking, and increased revenue to $7.5 billion for the first half of the year.

Slide 22 looks at our pivot to Asia. Asia's shares of revenue, profits, and loans have all increased in line with the changes we've made to the business mix since 2015. We continued to develop our Asia businesses in the first half of the year, in particular our business in mainland China. As I mentioned earlier, we received approval in June to establish HSBC Qianhai Securities, which we expect to launch in December 2017. This is a strategically important development for the Group that enables us to participate in China's rapidly growing domestic securities markets. To put this into context, without this licence it would be impossible for us to retain our number 1 ranking for fixed income in Asia ex Japan over the long term. This is obviously a new business that will require a period of investment, and we don't expect it to become a significant contributor of revenue for some time. But it remains a very important strategic addition for the long-term future of the Group.

We continued to win new mandates related to the China-led Belt and Road initiative in the first half of the year, and we remain the world's leading international bank for renminbi business. We were one of the first market-makers for the new Bond Connect in mainland China's Interbank Bond Market following its launch, and we underwrote both the first new bond issue, and the first 'Belt and Road Initiative' panda bond under Bond Connect.

Our strategic actions have helped us increase returns while strengthening our international network. Critically, they've also increased our ability to deliver industry-leading returns to our investors, as slide 23 shows. We have paid nearly $20 billion in dividends since 2015 and remain the second largest dividend payer in the FTSE. We have delivered a total shareholder return of 43% over the same period.

This is all evidence that our business is in good shape. The strategic actions we set out at our 2015 investor update are working. Our global businesses are performing well, and the strength of our global network is driving strong returns for the Group. Organic growth in revenue and lending is increasing, and we are investing more in the business to support this growth. We have comfortably exceeded our Risk Weighted Asset reduction targets while also growing revenue. Our cost saving programmes continue to create capacity for investment in growth, as well as investment in global standards, regulatory and compliance programmes. We remain on track to achieve the revised cost target that we set in April. We are focussed on delivering positive jaws over the remainder of the year. And we remain a well-funded business with strong capital generation and a diversified balance sheet.

We shall now take questions. The Operator will explain the procedure and introduce the first question.

Operator

Thank you, Mr Gulliver. Your first question comes from the line of Alastair Ryan from Bank of America. Please ask your question.

Alastair Ryan, Bank of America Merrill Lynch

Thank you. Good afternoon. On interest-earning assets growing at about a 4% annualised clip in the second quarter, is there anything you'd call out that would make that not representative of the pace that you're growing the Bank now, please?

Secondly on the margin, nice outcome in the second quarter – can that grow into the second half or are you dependent on HIBOR starting to move in order to get that going? Secondly on costs please, quite a strong message on the CTA finishing this year. How should we think about your cost targets into next year? Are they more in absolute terms or will they be driven by jaws? It looks like the exit run rate of costs is somewhat below where consensus thinks you'll be for next year? Thank you.

Iain Mackay

Thanks, Alastair. In terms of second half of the year, we'd certainly be inclined to keep the outlook consistent with what you're broadly looking at, at the moment. We clearly had a good first half of the year. I think you've seen over the years, Alastair, a bit of seasonality that comes through our numbers in the third and fourth quarter so, when we look at what you chaps from the sell side are looking at, for the

second half of the year, I wouldn't be inclined to change it too much, recognising some of that seasonality that we would expect to see. We're very encouraged by the first half of the year.

Net interest margin, broadly speaking, Alastair, we're looking at stability. Clearly, if we were to get more rate increases from the Fed at the end of the year, it wouldn't influence 2017 to any significant degree, but would be beneficial in 2018 and beyond. From where we sit, digging through the various components of net interest margin, we would be pretty happy with stability in the second half of the year. We continue to see some pressure on asset spreads, and the expansion in liability spreads is clearly a welcome feature, which offsets some of that pressure. There's nothing really out in the market that would suggest that you're going to see broad-based repricing of assets at this point in time.

In terms of costs going into 2018, we're clearly very focused on hitting the exit rate that we targeted in the middle of 2015 and expect to hit that. Going forward, we'll be informed by the same discipline around costs as we've had for the last couple of years and generating positive jaws for the business. We recognise that, as volumes grow and the opportunity to grow in the business, we would expect to see pressure coming through, simply from operating volumes in the cost base. Our focus will be very much on generating positive jaws through good cost control, reflecting on the level of revenues that we're generating. That would be the guidance that we would offer, going from 2017 into 2018. Thanks, Alastair.

Ronit Ghose, Citigroup

It's Ronit from Citi. I just wanted to pick up on a couple of points – one on growth and one on capital return. The loan growth numbers, to echo Alastair, were very strong in the second quarter. Iain, Stuart, could you just give us some more colour around what you're seeing, specifically in Hong Kong and Asia, and a sort of dig through the numbers you've presented today? You're seeing a 6% Q-on-Q increase in the Asian business. Hong Kong GBM loan growth looked really strong in the quarter. I just wondered if there are any unusual items in there. It looked like it was up 15% quarter on quarter in Hong Kong GBM. In Asia outside Hong Kong, CMB also looked very strong. Any colour around that would be great.

Separately, just to cycle back to capital, it's a question I guess you've had before. You were echoing this in your deck, but I just wanted to confirm. Previously, you said capital return or buybacks are explicitly linked to other capital actions. I'm just wondering; is this still explicit linkage or are you going to think about maybe loosening this? To what extent is this $2 billion for the second half any kind of indication of a future run rate or is it still very much event-driven? Thank you.

Iain Mackay

Ronit, thanks. Stuart will take the question on capital but, just looking at the growth numbers, you're right. We have good growth coming through Asia. That was really most noted within the Global Banking and Markets business and most noted within Hong Kong. I wouldn't say there's any particular feature of it other than, again, we've got a strong balance of corporate business within our Global Banking and Markets business. Those corporates are focusing on their financing needs for the year and getting them in place early on in the year, and that's the main driver within that.

More broadly, we saw good progress in Retail Banking and Wealth Management, and Commercial Banking. Nothing other than really the fact that we saw that investor appetite and confidence somewhat returning to our Asian markets, which was borne out by the growth that we were able to see coming not only through Credit and Lending, but more broadly the level of revenue generation that we saw coming through Global Liquidity and Cash Management, stability returning to Global Trade and Receivables Finance after a pretty difficult 2014, 2015 and 2016, in terms of volumes and commodity pricing. In CMB, again there was strong performance. Nothing outstanding, other than the fact of the mix of the customer base within the book and strong first-half performances, as they get their financing in place.

Stuart Gulliver

On capital, you're correct that we linked the first and second buybacks to the disposal of the operation in Brazil. This buyback is clearly not linked to the disposal of Brazil, so you're right to notice the fact that, effectively, we're now starting to regularly use share buybacks as part of the general toolkit that we have for capital management, but the way to think about this is that, clearly, we will first and foremost try to reinvest the capital in the business, in an accretive way. We'll obviously look to the fact that we have said,

again, that the dividend will be 51 cents for the foreseeable future and then we will also have a buffer that we will want to run for unforeseen circumstances. Before you ask what they are, by definition, they're unforeseen. Then last of all, if we have surpluses at that point that we think are above and beyond those three requirements, then we have now illustrated a propensity to buy back, this being the third one in 12 months, to a total of $5.5 billion.

What you should not assume is that we have a programme and that there will be regular buybacks. We will look at the criteria I've just set out, as we approach each, probably, half-year-end. We'll have a look at whether it's necessary for us to do a buyback or whether we actually have capital ratios that, at that point in time, are lower than where we feel it's necessary to do a buyback. What is different is, yes, share buybacks are now part of our toolkit and part of a regular toolkit that we'll use to manage the capital of the HSBC Group.

Ronit Ghose

Great, thanks for that, Stuart, Iain. Can I just have one supplementary, please? Just looking at the business areas, the Corporate Centre, I've seen all the significant items you've split out. It still looks like, even if I adjust for the significant items, that the revenues and also the bottom line are a few hundred million dollars stronger than previous quarters. Is there anything happening in the Corporate Centre that suggests this is a sustainable run rate or is it just noise and I shouldn't read too much into it, Iain?

Iain Mackay

No, I think it's pretty stable. BSM is kind of clocking along at the same annual run rate as we've had for the last couple of years. There's a little bit of variability that comes through those numbers based on gain or loss on AFS, as we reposition the book to take account of the rate environment and positioning for the longer term. Obviously we've got the rundown of US CML coming through; that's more of a negative.

I think the one area of volatility within these numbers, which we clearly saw last year and may continue to see some of this year, is the mismatch that we've got between own credit spread and our own debt, and hedging swaps, which clearly created some volatility in the fourth quarter of last year. No, Balance Sheet Management is running very much according to our expectations. US CML continues to run down. Legacy Credit was slightly favourable, with respect to credit and funding fair value adjustments. Operating expenses are largely where they are and the main associates that sit within that as well are very much in line with expectations, so nothing particularly odd and we will clearly keep you posted as we continue to manage that volatility within our own debt and hedges.

Chris Manners, Morgan Stanley

Good morning. It's Chris from Morgan Stanley here. Just two questions, if I may: the first one was on Balance Sheet Management. Revenues look like they were down a couple of hundred million quarter on quarter, but I suppose curves are a bit steeper; US rates are up. I know the average of HIBOR was down. I know, Stuart, you used to guide us to balance sheet management revenue numbers. Is there any guidance you could give us there and maybe explain a little bit of the dynamics, because they were a little bit softer than I thought?

The second question was on impairment. It looked like a really good impairment quarter. I know you didn't get the recurrence of the oil and gas impairment you had before, and it did look like Asia ticked up a little bit. As I look at $663 million of impairment charge in the first half, $3.5 billion of impairment charge in the consensus for next year, are there any credit blackspots or anything we should be worried about or do you think that impairment charge could come more behind than people are expecting?

Stuart Gulliver

Let me just take BSM. BSM, $2.5 billion to $2.7 billion, no real change there. Just one thing to bear in mind though is that, in a rising rate environment, BSM initially will do slightly less well, because you get the repricing come through. The benefit will be seen in RBWM and CMB, and that's what you should expect to see. As rates start to rise, CMB and RBWM will benefit. You can see that in both sets of numbers, really from the first quarter onwards, actually probably fourth quarter of last year a little bit and then the first and second quarters of this year. BSM will be slightly softer because, effectively, BSM makes the majority of its money either when the curve is very steep and/or rates are going down.

Therefore, when rates are going up, the converse happens, but I would still guide you to $2.5 billion to $2.7 billion, and obviously we're assuming rate rises there, but you won't see bigger numbers than that. As I say, the bigger numbers actually will be coming in RBWM and CMB. On LICs, I'll pass it to Iain.

Iain Mackay

On impairments, Chris, there's just a very stable picture across our portfolios around the world. We had two specific names in Global Banking and Markets in Asia against which we made provisions, nothing common from a sectoral perspective. Probably the underlying feature was more to do with fraud than it was to do with business performance or economic drivers but, beyond those couple of names, we were very, very stable within our retail portfolios around the world, most notably obviously the biggest markets of Hong Kong and the UK. Commercial Banking credit was again stable and Global Banking and Markets in the round was a very stable picture.

I think that part of the comparison is clearly aided by the fact that, in the first half of last year we had significant charges in oil and gas, and one name being provided for in the metals and mining sector, which did not recur. Overall, we had continued conservatism and prudence from underwriting, great consistency across the portfolios, as the risk teams are doing a good job in that regard with the businesses, so stable.

Chris Manners

Perfect, so I guess do you think, with LICs at such a low level, you're taking enough risk?

Iain Mackay

Yes. Thanks, Chris.

Stuart Gulliver

That was pretty emphatic.

Raul Sinha, JP Morgan

Afternoon, everybody. Could I have two, please? The first one is following up on Stuart's discussion about the buyback and the capital ratio. Obviously I understand that the core tier 1 is going to go down by 20 basis points because of the buyback, but that still leaves you well in excess of your 13% target. If I look at the scrip take up of this Group this year, I think it's about $2.8 billion so far, so the buyback this year is broadly offset by the scrip dividend. Just when we think about the core tier 1 ratio, what magnitude of timeframe do you think we're going to head back towards the 13%? That's the first one.

Iain Mackay

Raul, just keep in mind, as I'm sure you do, that at the end of this year we'll have a transition adjustment coming through common equity tier 1 and IFRS 9. We'll talk to you about that in more detail later this quarter/early in the fourth quarter. I'm not going to give you a sizing of that. The sizing hasn't changed as we continue to work through the analysis, but we'll give you specifics around that later. That's going to drop the common equity tier 1 ratio by a few basis points. I'll keep you guessing as to exactly how many, but that's going to drop it off.

Then there are still a number of areas out there with respect to significant uncertainty in the regulatory front, most notably around revisions to Basel III, where the dialogue continues, but with no clarity as to how that dialogue's going to settle down. That still, for the banking industry probably outside the UK, frankly, and to a lesser extent inside the US, represents risk in terms of RWA inflation and consequential knock-on to the common equity tier 1 ratio. Add to that not insignificant geopolitical uncertainty. I think it goes again to Stuart's comment around the need to maintain some prudence and a management buffer within this.

We're clearly happy with the strength of the capital ratio in terms of more than being supportive to the growth opportunities in the various markets across our network, around the propensity to support the dividend, the propensity to support buybacks, but there are still a couple of features out there that we've

got to settle down. If you've got any particular insight as to when exactly that's going to settle down beyond IFRS 9, I'd love to hear about it, but it's still a pretty uncertain picture.

Raul Sinha

Okay, that's really helpful, Iain. Can I have a second one, please, just on CMB and the trends in the revenue line within that? There are some pretty divergent trends, particularly weak performance in Global Trade and Receivables. I guess that's probably margin pressure. Could you give us some colour on what's driving that in terms of geographies? Then there's a market products and other line in CMB as well, which seems to be a little bit volatile and quite hard to forecast. If you could give us some colour on what's going on there that would be useful as well, thanks.

Iain Mackay

Yes, absolutely. That last one, Raul, is lower insurance revenues coming through. That's where we book insurance revenues within the CMB business. The majority of our insurance revenues are booked through Retail Banking and Wealth Management, but there is a component that comes through insurance and there were lower insurance revenues in CMB this quarter.

Going to Global Trade and Receivables Finance, broadly speaking, we're seeing some return to stability in that regard. We saw higher numbers in Asia, which broadly had higher balances and volumes. Pricing is still very much under pressure in that product space, particularly in the plain vanilla and documentary credit standpoint. We saw lower revenues coming through the Middle East and North Africa, and that was primarily driven by repositioning and the exit of customers, as we continued to just ensure we've got absolutely the right composition of the portfolio from a financial crime risk management perspective. As we work through and complete our work on back-book validation from an AML standpoint, that's part of what contributed to some of the pressure in Global Trade and Receivables Finance in Middle East and North Africa. Broadly, the GTRF team is encouraged by the fact that we're beginning to see volumes improve; there's some semblance of stability returning to commodity pricing. It's certainly a more encouraging picture in the first two quarters of 2017 than was the case in 2015 and 2016.

Manus Costello, Autonomous Research

Hi. I wanted to dig into the costs little bit more, please. I wonder: can you give us a bit more colour on exactly where you're spending this extra $300 million in retail, so we can get an idea of what your priorities are when you've got flexibility to invest? What should we think about going into 2018? To come back at Alastair's question a different way, are you prepared now to make additional investment and, therefore, that $7.1 billion exit number that we're looking at for this year will step up into next year? That's the way that I was reading that extra investment.

Secondly, just a small one on the one-off: I notice that you started putting in a Brexit charge into your exceptional items. How big do you think that's going to end up being?

Stuart Gulliver

The Brexit charge was $4 million, which is legal fees so far, but probably it'll be a few hundred million, yes.

Iain Mackay

A lot less than ring-fencing.

Stuart Gulliver

It'll be $200-300 million.

Iain Mackay

More broadly on costs, Manus, the investment is focused largely on North America and, within North America, predominantly Canada, in terms of automating platforms, growing market share, in actual fact recapturing market share that we have surrendered over the course of the last couple of years. We got that investment under way in the first half of the year. It will be largely completed by the end of the year,

so we do not expect to see that sitting in the run rate as we exit. The exit remains broadly consistent with what we've talked about, in terms of $7.1-7.2 billion quarterly exit rate.

In terms of moving into next year, Manus, going back to my comments to the question earlier on costs that Alastair asked, again, it should very much be positive jaws. As we see the opportunity to see growth in the markets across the network that clearly has volume implications, in terms of the pressure that that puts on operations, whether it's more credit card production and more loan documentation, service calls, collection calls and so on and so forth, but also the investments that we will make to support that growth. The guiding features will be, one, maintaining discipline, very strict discipline, around cost management informed by a propensity to generate revenue growth and, within that context, generating positive jaws. That is for us the guiding metric - positive jaws. It's not necessarily keeping costs flat. We are not looking to starve the business of investment, quite the contrary. Through these cost-saving programmes we've executed over the last two or three years, it is very much about creating capacity to build investment in the capabilities of the business.

Manus Costello

The jaws you have delivered, I think, of 0.5% – is that the level of positive jaws we should think about?

Iain Mackay

Positive jaws we would be happy with. We had 1.6% in the second quarter, 0.5% for the year. But if you look at the global business breakdown, Retail Banking and Wealth Management had very strong positive jaws of 8.3%; I think Global Banking and Markets had positive jaws of about 5%; and I think Commercial Banking had1.5% positive jaws. So, we're not looking to generate 8%; that would suggest necessary that we're probably not investing at the right level. But a couple of percentage points that creates capacity for us to take those investment decisions as and when we think is appropriate would be a nice thing to accomplish – but positive jaws is the driving force, even if it's only 0.1%.

Manus Costello

Thank you very much.

Rohith Chandra-Rajan, Barclays

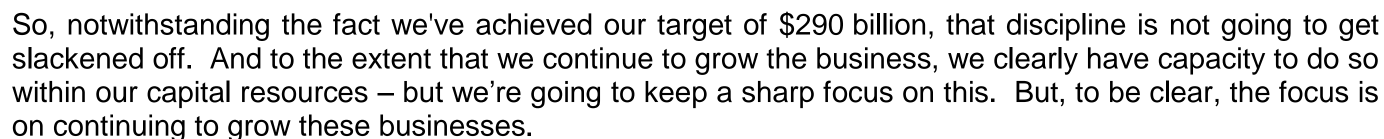
Hi, morning there. Just a couple of quick follow-ups – hopefully quick, anyway – if I could, please. The first one's just on RWA growth for the second half of the year, just, Iain, coming back to your comments around loan growth and then also the model changes in GB&M. So, if I interpreted your loan-growth comment correctly, it sounds like there might be a bit of a slowdown in the second half if some of the GB&M performance was perhaps to pull forward from what you expected later in the year, so I wanted to check if that was broadly in line with your thinking. And then the timing of the 20 billion RWA reduction from GB&M – is that something for the second half of this year or is that longer dated?

And then the second one was just a follow-up on Chris' credit-quality question. Given that, I guess, the gross charge picked up to 45 basis points in the second quarter, you flagged a couple of, I guess, notable one-offs. That 45 is not particularly high, but should we expect that to go down in the second half? Thanks.

Iain Mackay

Okay, RWA growth – let me go to the models question first. That is dependent on PRA approval and, therefore, sadly I cannot predict whether it's second half or into next year. Clearly, we are working very closely with our regulator to get those model approvals in the second half of the year, but that one is a little bit out of our hands.

In terms of overall RWA development, clearly our focus is on growing the business. As we talked about earlier, the first half was particularly strong. I wouldn't necessarily be encouraging you to refocus on what you've already got for the second half of 2017 either in terms of revenue or balance sheet growth outlook, but, to be clear, where we are from a capital management perspective – where RWA sits very much at the centre of – the discipline within the business continues to be on improving the overall profitability of the customer relationships that we have, so there is a constant focus on taking less profitable performing business and repositioning that into more profitable product and relationships.



So, notwithstanding the fact we've achieved our target of $290 billion, that discipline is not going to get slackened off. And to the extent that we continue to grow the business, we clearly have capacity to do so within our capital resources – but we're going to keep a sharp focus on this. But, to be clear, the focus is on continuing to grow these businesses.

Rohith Chandra-Rajan

Thank you. And just on the credit-quality point?

Iain Mackay

Look, the charge step-up – yes, we had a couple of names in Asia that stepped up, but also, as we grow our businesses in Mexico – we continue to grow business in Mexico – that growth is coming across the businesses but is also largely informed by what we are doing in Retail Banking and Wealth Management, where, as we grow the retail-banking product, there is an embedded higher loan-impairment charge within that, and that is what is contributing to the higher gross charges in the first half of the year. But that is really the only feature.

When you look across loan-impairment charges by business, by geography, it's very, very stable. It's in line with expectations – in addition absolutely including the Mexican market, where we continue to grow balances within retail banking. Predicting exactly where this goes in the second half of the year is mission impossible, but we're very happy with the stability and quality being demonstrated by credit portfolios.

Rohith Chandra-Rajan

Thank you. I guess I just want to have a look at the gross charge Q1 to Q2. It was 30 up to 45. The LATAM charge was fairly stable, so that does suggest, actually, that the change was pretty much driven by the stuff you highlighted in Asia.

Iain Mackay

That was the lion's share of it.

Rohith Chandra-Rajan

Okay, thank you very much.

Claire Kane, Credit Suisse

Hi there, just a follow-up to some of your comments around the second-half revenue outlook. I think you're suggesting that you're happy with the consensus there. Given we obviously have a stronger volume number and you're guiding to stable margins, are you concerned more about the non-interest income environment and perhaps could you comment on how July has been so far?

Iain Mackay

July has been reasonably consistent, but when you look at the non-interest income component, there's a significant component of that, that comes through Global Banking and Markets. And if you look at seasonality in Global Banking and Markets, notwithstanding the stability of revenue streams within that, it is dependent on a higher proportion of non-interest income revenues, and that is clearly seasonality we've experienced historically in that business. And it's again, informed by the composition of our portfolio. We've got a higher proportion of corporates relative to other groups when we reflect on composition versus financial-institution group.

But, no, we're looking at overall levels of activity, and we think consensus right now for the second half probably reflects where we think we're headed.

Claire Kane

Great, thank you.

Tom Rayner, Exane BNP Paribas

Good morning, Iain. Morning, Stuart. Just listening to a number of the answers you've given to the questions, I'm just sort of wondering if there's any change in your philosophy here about what HSBC is. Are you starting to view HSBC as more a growth story now? The reason I ask that is slide 30, which has a nice breakdown of the underlying loan growth, shows a second-quarter annualised growth rate in the double digits, yet I think, Iain, you said there wasn't anything particularly unusual distorting that. On the costs, there's a very clear message: you're sort of happier now to think about positive jaws, not sort of sticking to some sort of flat cost target. And if we have better revenue we shouldn't necessarily be surprised, I guess, to see the cost growth picking up. And then on the capital return, Stuart, the way I'm interpreting it, 100% maybe of free cash flow to be returned to shareholders over time, but fairly clear about what the free cash flow is, i.e. once you've invested everything you can in RWA growth at the right sort of return level. Am I interpreting all this correctly or am I, as usual, trying to read too much into things? Thanks.

Stuart Gulliver

I think the capital you're interpreting correctly. The capital you're definitely interpreting correctly. That's an easy one. And are we saying this is a growth story? Well, there are a lot of things growing. The loans and advances are growing; the revenues are growing; we've got positive jaws. And we're saying we will invest where we can get positive jaws, because we're not going to starve the business. How you characterise that is up to you.

Iain Mackay

We have kind of always viewed it as a growth business. We just had a bit of work to do to be able to demonstrate that.

If you go back even to 2011, Tom, think about the number of transactions we've done over the last six and a half years within the business.

Stuart Gulliver

Tom, we've sold 97 businesses. The headcount has gone from 330,000 down to 230,000. There's been quite a big piece of restructuring. We will have taken $6 billion out of the cost base etc, so you could argue there is a more focused, more logical, cohesive set of businesses that now remains. And, yes, I think there is absolutely growth in these numbers.

Tom Rayner

Thank you, and well done.

Stuart Gulliver

Thank you.

Michael Helsby, Bank of America

Morning, gents. I've got three questions, if that's alright. First, on capital, on page 2 of your interim report you mentioned the CCAR and obviously the US passed what you'd asked for. I was wondering if you could enlighten us on what it was you actually asked for in the CCAR from capital distribution.

Second is on the tax rate. The effective tax rate in the first half was 21%. I was just wondering if that was reasonable, adjusting for the levy obviously in the second half – tax rate to think about going forward. And I was wondering, with all the talk of tax cuts in America, what the sensitivity of the tax rate would be to a given fall in the US corporation tax rate?

And, finally, thank you for the extra disclosure on the UK credit risk. Some quite interesting things to draw out, but your SVR of 5% is very low – very low relatively to the industry. And it's interesting that you give us the interest-only mix. So, that's at 26%, which is actually broadly in line with the industry, so the SVR is low despite having the interest-only component. So, I was just wondering, why is your SVR so low? What are you doing differently to other banks in the UK, who have got much bigger SVR proportions?

And I was wondering if you could tell us what the yield on your mortgage portfolio is in the UK at the moment and also what the gross share you took in Q2 in terms of mortgage sales? Thank you.

Iain Mackay

So, stock of mortgage share in the UK is just over 6%. I do not have the specific gross yield on the mortgage book as a whole in the UK. We can get back to you on that one, and we'll get back to you on the SVR as well, because I have absolutely no clue as to why we've got a lower proportion of SVR compared to the market. I think it's just largely around how we position different products within the channel. But we'll come back to you on those points within the UK mortgage book.

In terms of the tax rate, 21-23% is the range within which we would think the effective tax rate is most appropriately positioned, when you think about the composition of profits around the globe – that generated from Asia, the UK and the US. So, it's reasonably normal. Obviously, last year with disallowances around goodwill, significant charges from litigations, customer redress fines and penalty very much distorted the effective tax rate in the second half of last year, which was about 53%. Now, that effective tax rate, which I gave you, again, obviously is before you include the effect of the bank levy.

In terms of the impact of lower US rates, well, first of all, you have to believe that it's going to happen. And, if it does, it's unlikely it's going to happen in the near future. In the longer term, lower US tax rates clearly would be beneficial to HSBC. In the short term, we would have to revalue the deferred tax asset – and that almost certainly would result in an impairment in the deferred tax asset, some of which we get back through the capital line, because obviously it would reduce the deduction from capital for deferred tax assets. So, needless to say not a straightforward answer, because it's never straightforward when it comes to the impact on capital. But, clearly, if the tax rate were to be reduced from where it is presently, in the 30s, down to, for example, in the low 20s, there would be some impact on the US deferred tax.

Now, if you took an extreme scenario – for example, if the US corporate tax rate dropped to 15% – you'd have a deferred tax asset write-down in the first instance flowing through the P&L of about $2-2.5 billion, but we would give some of that back through the capital calculation.

In terms of what we asked for on the capital plan in the US, sorry, not sharing that. Safe to say we had a capital plan that made recommendations around the return of surplus capital from the US business to the parent company over the same sort of timeframe that I talked about when last addressing this topic a quarter ago and two quarters ago and three quarters ago, in actual fact. So, we are very focused on returning surplus capital from the US to the parent company, and that was what was in our capital plan, which raised no objection from the Federal Reserve.

Michael Helsby

Thank you. Can I just push back? Why is it a sensitive number? Why don't you want to tell the market what you've asked for?

Iain Mackay

Frankly, to keep some flexibility around how we manage our capital.

Michael Helsby

Right, okay – fair enough. Thank you.

Iain Mackay

Thanks, Michael.

Martin Leitgeb, Goldman Sachs

Good morning, also, from my side. Just two questions from me. The first one just to follow up, again, on loan growth – and I apologise on that, but obviously I think the 3% growth figure in the second quarter draws a lot of attention. I was just wondering, how should we think about the loan-to-deposit ratio evolving over time? I remember some time ago HSBC coming down from a level of below 90% with a target to remain below 90%. And an inflection point becomes visible around the fourth quarter, from

which the loan-to-deposit ratio has edged higher towards 70% and over 70% now. How should we think about that going forward? In this context, also looking at your capital and funding position, would small acquisitions – loan books or similar – be something you would consider, if it's the right opportunity, in order to increase lending?

And the second question related to the UK, which obviously you refer to as one of the growth areas. And I was just thinking, how should we think about market pricing in UK retail going forward? We have one, the TFS window closing around February next year and second, the comments from the PRA on unsecured and probably some too-cheap market pricing in unsecured. Would you expect that the impact of both could be that pricing and asset yields would increase in the UK? Thank you.

[*There was a brief interruption to the telephone connection.*]

Iain Mackay

Hi, Martin. Sorry about that. So, yes, we're talking about the A/D ratio, the advances/deposits ratio. So, look, yes, there's absolutely capacity both from a capital and from a funding perspective to grow the loan book. It's encouraging to see the A/D ratio move from a low of 67.7% a couple of quarters ago to just over 70% now. Maintaining that momentum would be good.

On acquisitions the story really hasn't changed. Are we building capability for a big acquisition? No. If there were small portfolios that were complementary to our business, it's certainly something we would consider and actually have considered over recent years with some very small portfolios in markets over the last five or six years.

In terms of UK growth – I'm really sorry – can you repeat your question for me?

Martin Leitgeb

Yes, the question was more regarding the outlook for pricing in UK retail lending. And the background is the TFS drawing window, which some think has led to some compression on the mortgage side, closing as of the end of February. And equally there have been some comments by the regulator with regard to aggressive pricing in unsecured lending. So, the question is whether you would expect or you see already some of the upwards pressure in margins and pricing?

Iain Mackay

That's been a feature of net-interest margin for the last few quarters. There has been pressure on pricing in the UK market and in mortgages in particular – less so across the unsecured book, principally because we've got a smaller proportion of UK unsecured lending overall, again, and a fairly conservative position within that.

But there's no question about it: within UK retail banking, there has been pricing pressure on the assets side for quite some time now. Whether unwinding of QE in the UK would necessarily ease that, I'm not quite sure. Because a number of our competitors have been really quite aggressive about attracting deposits in terms of paying for deposits and bank transfers, so people are clearly focusing on diversifying their sources of funding within the UK market. But there's no evidence at the moment that we're seeing any re-pricing opportunity within the UK retail market.

Martin Leitgeb

Thank you very much.

Iain Mackay

Thanks, Martin. So, sorry we got cut off there. I don't know if there are any last questions coming from the group.

Stuart Gulliver

Okay, well, thanks very much everyone for joining the call.

Iain Mackay

Thank you.

Stuart Gulliver

That brings the analysts' call to an end, thank you.

Forward-looking statements

This presentation and subsequent discussion may contain certain forward looking statements with respect to the financial condition, results of operations and business of the Group. These forward-looking statements represent the Group's expectations or beliefs concerning future events and involve known and unknown risks and uncertainty that could cause actual results, performance or events to differ materially from those expressed or implied in such statements. Additional detailed information concerning important factors that could cause actual results to differ materially is available in the HSBC Holdings plc Annual Report and Accounts 2016. Past performance cannot be relied on as a guide to future performance.