Edited Transcript
3Q 2015 Earnings Release
Conference Call with Investors and Analysts

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

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Stuart Gulliver, Group Chief Executive

Good morning from London and welcome to our third quarter results call for analysts and investors. With me in the room is Iain Mackay, who's our Group Finance Director. We've also got Douglas Flint, our Group Chairman, who's on the phone in Shanghai.

Let me start by pulling out a few key highlights. Our third quarter performance was resilient against a tough market backdrop. Reported profit before tax for the third quarter was 32% higher than the third quarter of 2014 but adjusted profit before tax was lower by 14%. The drop in adjusted profit before tax was mainly due to a 4% drop in revenue. In particular, the stock market correction in Asia affected Principal Retail Banking and Wealth Management. Revenue was also lower in Global Banking and Markets. Despite slowing growth in the mainland Chinese economy and market volatility in Asia, there has been no visible impact on our Asian credit quality in the quarter and we've included some facts and figures on our business in mainland China in the appendix.

Operating expenses were up against the third quarter in 2014, as expected, although our cost reduction programmes have started to gain traction. We continue to implement the strategic actions we set out at our Investor Update, and in particular we reduced risk weighted assets by a further $32 billion in the quarter, bringing the total reduction to $82 billion since the start of the year.

Iain will shortly give a detailed overview of our financial performance and then I will give a progress report on the actions from our Investor Update. First, though, Douglas has a few comments on the Group headquarters review.

Douglas Flint, Group Chairman

Thanks very much, Stuart. As you know, in April the Board asked management to start work to look at where the best place is for HSBC to be headquartered. I should stress that although management is undertaking the review on behalf of the Board, it is of course the Board that will make the final decision. The purpose of the review is to assess the best location for the holding company to maximise the present and future strategic opportunities of the Group and long-term shareholder value. This is therefore a decision based on long-term perspectives rather than short-term factors.

A significant amount of work has already been carried out on this review since April, supported by a number of external advisers, but there's still a considerable amount left to do. As our discussions have progressed, further information has been requested by the Board on topics that we presented and on fresh areas of interest, and while we set a target for completion at the end of 2015 at the time of our Investor Update, this is a self-imposed deadline that we will move if the Board requires further work to be performed. So, an announcement will be made when the Board finally makes its decision; otherwise, a further update will be provided at the time of our full year results announcement.

Stuart Gulliver

Thanks, Douglas. So, Iain will now take everyone through the numbers.

Iain Mackay, Group Finance Director

Thanks, Stuart. Reported profit before tax for the third quarter was $6.1 billion, up 32% on the third quarter of 2014. The increase in reported profit before tax was mainly due to a net-favourable movement in significant items. Fines, settlements and customer redress were down by $1.4 billion and we benefitted from favourable valuation movements on our own debt of $926 million. Adjusted profit before tax was $5.5 billion, down by $912 million or 14%. You'll recall that the adjusted measure excludes the period-on-period effects of foreign currency translation differences and significant items. You'll find more detail on these adjustments in the appendix in the investor deck.

Looking at some key metrics for the first nine months of the year, the annualised reported return on average ordinary shareholders' equity was 10.7%. The annualised reported return on average tangible equity was 12.1%. And on an adjusted basis, we had negative jaws of 4.1%. You'll notice that jaws has worsened since the first half of the year, when we had jaws of negative 2.9%. Whilst we're not changing our positive jaws target and have a very sharp focus on cost management, it is clear we will not

accomplish positive jaws for the full year. The main driver of the deterioration in jaws is the fall in revenue in the third quarter. While revenue fell in the quarter, we also slowed our cost growth. Savings are beginning to flow to our cost run rate, but a great deal remains to be achieved. More on this in a few minutes.

The next few slides look at the third quarter relative to last year's third quarter, then I'll summarise the nine month performance. Adjusted revenue was $657 million, or 4% lower than the third quarter of 2014. This was mainly due to lower revenue in both Principal Retail Banking and Wealth Management and Global Banking and Markets. Principal Retail Banking and Wealth Management revenue was down due mainly to a fall in Wealth Management income in Hong Kong. This was caused by the stock market correction in Asia, which reduced asset valuations in our life insurance manufacturing business. Overdraft fees in the UK fell again due to re-pricing and the creation of a text message service to alert customers when they go overdrawn. Global Banking and Markets revenue was also down. This was due to the impact of challenging market conditions on Rates, which was down by 22%, and Credit, which was down by 51%. Revenue also fell by 14% in Foreign Exchange, but this was relative to a particularly strong quarter last year. By contrast, revenue rose across most other client-facing Global Banking and Markets business lines, which included Equities, where revenue was up by 23%, and Capital Financing, which was up by 9%.

On adjusted operating expenses, I'll update you on our third quarter costs, then I'll cover our progress against the cost target from our Investor Update. In the third quarter, adjusted operating expenses increased by $191 million compared to the third quarter of 2014. This reflected higher change-the-bank costs, which came principally from increased spending on regulatory programmes and compliance. Run-the-bank costs remained broadly flat over the period. Staff costs were higher as a consequence of inflation in Latin America and Asia, whilst the performance-related staff costs fell in Global Banking and Markets, mainly reflecting lower revenue in the quarter. The reduction in other costs largely reflects the continuing run-off of the US CML portfolio.

As you know, we set a target at our Investor Update to deliver our 2017 exit run-rate costs at the same level as 2014. There were early signs of progress against this target in the third quarter. The chart on the left hand side of the page shows our 2014 operating expenses, excluding Brazil and Turkey and adjusted for the latest foreign exchange rates. This gives a baseline 2014 cost figure of $31.8 billion. We included the bank levy in the 2017 target we used for the Investor Update, but we've excluded it here as our third quarter cost figure does not include the bank levy. This gives us a target figure of $30.2 billion, which is equivalent to a quarterly ex-levy run-rate of $7.6 billion. Looking at the middle chart on the right side of the slide, you'll see that our costs in the third quarter of 2015 were $7.9 billion. We need to continue making cost savings through 2016 and 2017 to offset both inflation and investment to fund business growth, so there is still a great deal to do.

The same chart also shows our quarterly cost trend. We reduced our costs by $392 million relative to the second quarter. There were a number of specific items in the second quarter which did not recur in 3Q15, including the Financial Services Compensation Scheme levy. We started to see the early impact of our cost-reduction programme in Q3. To be clear, our cost management is focused on achieving positive jaws, in effect informed by the revenues the firm can earn.

Adjusted loan impairment charges were up $81 million, or 15%, compared to 3Q14. This increase was mainly in North America, driven by lower releases in the US CML run-off portfolio. LICs also increased in the Middle East and North Africa, notably in the United Arab Emirates. There were improvements in individually assessed charges in Latin America and Europe, notably in Brazil and the UK. Loan impairment charges in Asia were also slightly lower and, as Stuart said, we've not seen any significant deterioration in credit quality.

Turning to a nine month comparison, adjusted profit before tax was $605 million lower than 2014. Adjusted revenue was $675 million higher than the first nine months of 2014, with growth of 5% in Global Banking and Markets, 3% in Commercial Banking and 1% in Principal Retail Banking and Wealth Management. Operating expenses for the nine months were $1.4 billion, or 6%, higher than 2014. This reflected salary inflation in Latin America and Asia, investment to support growth in targeted areas, and increased spending on staff and infrastructure in regulatory programmes and compliance. Adjusted loan

impairment charges were down by $58 million, or 3%. The ratio of loan impairment charges to average gross loans and advances to customers remained stable at 20 basis points. This number excludes Brazil.

Turning to capital, the Group's Common Equity Tier 1 ratio was 11.8% at the third quarter against 11.6% at the half year. This increase reflects continued capital generation of $1.9 billion from profits net of dividends and regulatory adjustments, together with the impact of risk-weighted assets initiatives. At our Investor Update, we set a target to reduce the Group's risk-weighted assets by $290 billion by the end of 2017, roughly half of which will come from resizing Global Banking and Markets. The chart in the top right of the page shows this target adjusted for foreign exchange rates as of 30 September. This gives a baseline risk-weighted asset reduction target of $275 billion. In the first half of the year, we reduced risk-weighted assets by $50 billion, $31 billion of which came from Global Banking and Markets. In the third quarter, we reduced risk-weighted assets by a further $32 billion. This brings the total risk-weighted asset reduction so far to $82 billion, which is 30% of our target. $19 billion of the reduction in Q3 came from Global Banking and Markets. This included some reductions in incremental risk charge positions, as well as lower credit conversion factors from the use of more granular data. A further $11 billion came from Commercial Banking.

This next slide shows our Group return metrics. The annualised reported return on average ordinary shareholders' equity for the first nine months of the year was 10.7% and the annualised reported return on average tangible equity was 12.1%. Both of these are significantly up on last year. Also for the first nine months of the year, the annualised reported return on risk-weighted assets was 2.2%, compared to 1.9% in 2014. Whilst it's early days, our programme to reduce risk-weighted assets is progressing well. We continue to work towards our adjusted return on risk-weighted assets of greater than 2.3% by 2017.

I'll now hand back to Stuart to provide an update on progress around our strategic actions.

Stuart Gulliver

This slide provides a summary of our main achievements to date. The focus of management has been firmly fixed on implementing the nine business actions that we announced at our Investor Update on 9 June.

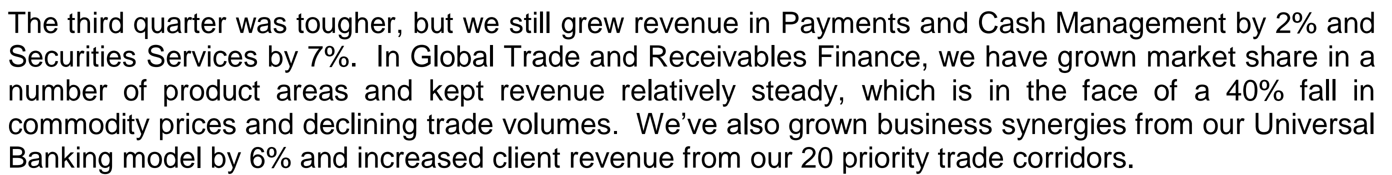
The main news in the third quarter was the reduction of a further $32 billion of risk-weighted assets. Iain has already covered this in some detail, but I can also tell you that in the last few days we have agreed to sell a portfolio of real-estate secured loans from the CML book in the United States, which we expect to reduce risk-weighted assets by more than $4 billion. We continue to work very hard to reduce our risk-weighted assets quickly and efficiently.

We're also making progress on costs. We have removed around 100 software applications, achieved around $130 million of annualised procurement cost savings and completed around a third of our manual payments automation programme. We have also made good progress in increasing our digital capabilities, which saves money and provides a better customer experience. There is much more to achieve on costs, but the trajectory is in the right direction and the vast majority of our cost programmes are now underway. Taken together, we expect the cost programmes that we've already started to deliver around 90% of our cost target, with further opportunities to be fleshed out in the next few weeks. Obviously, this will be an incremental process and some will take longer than others, but now that we've mobilised these programmes we expect to see results in the coming quarters.

Turning to other areas, you'll know from the half-year that we agreed to sell our Brazil business to Banco Bradesco, and that deal remains on track. There is no update on Turkey just yet and I expect that to take a little longer.

Rebuilding NAFTA profitability is a work in progress and will remain so until the end of 2017. However, the initial signs are positive. Revenue is up by 20% in the United States compared to the third quarter of 2014, and profits were up for the first nine months of the year in the United States by 85% and in Mexico by 95%. I continue to monitor Mexico and the United States personally and speak frequently with country heads to make sure we maintain momentum.

Our international network has generated significant revenue growth in 2015. We've grown revenue from transaction banking products by around 5% in 2015, with Foreign Exchange in particular growing by 10%.



The third quarter was tougher, but we still grew revenue in Payments and Cash Management by 2% and Securities Services by 7%. In Global Trade and Receivables Finance, we have grown market share in a number of product areas and kept revenue relatively steady, which is in the face of a 40% fall in commodity prices and declining trade volumes. We've also grown business synergies from our Universal Banking model by 6% and increased client revenue from our 20 priority trade corridors.

Good progress has been made in targeting growth in Asia. In the Pearl River Delta, we continued to recruit staff to capture growth. We're also announcing today that we have signed an agreement, which is subject to regulatory approval, to establish a majority-owned joint-venture securities company in Qianhai, Shenzhen. If approved, this would be the first majority foreign-owned securities company in mainland China and would potentially allow us to engage in the full spectrum of securities business in the country.

In ASEAN, revenue is up by 6% year-on-year. We've extended our leadership position in RMB internationalisation and grown revenue from renminbi services by 8% year-on-year. In September, we issued the first Panda Bond by a foreign commercial bank in China's inter-bank bond market; and in October we were among the first banks to connect to the Cross-border Interbank Payments System for cross-border RMB clearing, and we were also the Joint Global Coordinator and Bookrunner for the RMB 5 billion bond issued by the People's Bank of China in London. This was PBOC's first debt offering outside of China and a significant milestone on the path towards the internationalisation of the RMB.

Delivering on our strategic actions obviously remains our primary focus and we'll provide a further update on our progress at our full year results in February.

We'll now take questions.

Raul Sinha, JP Morgan

My first question is just to explore the weakness in the revenues and get a sense of how much of that is a step down versus just a weak quarter. Would you expect any recovery in the Wealth Management business in the fourth quarter? And related to that, clearly, last year in Q4 GB&M had a really weak quarter. Given that we're in November, I was wondering if you might be able to tell us whether you're seeing sort of a repeat of that weakness this year as well.

The second question is also slightly related. I was wondering if you had seen any impact of your RWA initiatives on revenues. I don't think there was any. You talked about $400 million sort of ongoing revenue impact. When do you expect to see that coming through on the revenue line?

Stuart Gulliver

Retail Banking and Wealth Management had an extremely strong first half and in a way has given back some of that extremely strong first half. As the Hong Kong-Shanghai Stock Connect took off and those equity markets rallied very strongly, in a way, some of what we've seen in the third quarter, although it comes through the life insurance manufacturing revaluation of the book, is effectively the same thing being reversed. So, from an RBWM perspective, we've seen stabilisation in October but we've obviously not seen a recovery back to the volume levels that you saw going through the Hong Kong and China market in the first half.

For Global Banking and Markets, October has been a reasonable month, although probably erring towards the sort of tougher side, but you're right that the fourth quarter of last year was particularly weak for Global Banking and Markets, and so far there is not a sign of a repeat of that level of weakness in October.

Iain Mackay

On RWA, I think your read of it is exactly right, Raul. In terms of the first half of the year, we largely saw disposition of legacy positions, which, as we talked back in June, would have de minimis impact in terms of revenues. What we've seen coming through a lot in the third quarter is really improvement in terms of the measurement of risk-weighted assets, in terms of improving the granularity, recognition of collateral, reduction of positions that have an impact on the incremental risk charge through the markets business, for example. So, thus far we have not seen a significant impact in revenues from risk-weighted asset actions that we're taking.

Now, obviously the focus, as Stuart mentioned, is very much on maintaining momentum around overall risk-weighted asset reduction initiatives. Quarter-on-quarter we're going to see a little bit of a mix between dispositions of legacy assets, run-down and close-out of less profitable customer positions, improvements in the overall quality of granularity of data which relates to individual customer positions and how that's reflected through risk-weighted asset calculations, and, obviously subject to regulatory approvals, any refinements to models.

Chintan Joshi, Nomura

I've got two questions, one on RWAs and one on trade finance. If I can take the RWA one first, you had a $5 billion increase from growth initiatives this quarter. If that repeats next quarter, we're talking about $32 billion for the year. That looks well below the run rate of the guidance, and clearly post the investor day the market has deteriorated – you know, macro has deteriorated. I'm just wondering what kind of growth are you seeing? Where should that $180-230 billion range rebase down to? And while we're talking about RWAs, also, in GB&M, or generally across the Group, if you could tell us how much of the improvement has been from model changes versus actual run-down of RWAs.

And if you could just give us some colour on trade finance volumes and margin trends across both GB&M and CMB. DB this morning has reported quite challenged trends. I'm just wondering what you are seeing here.

Stuart Gulliver

On RWAs, we talked about redeploying $180-230 billion, and then I think at the last results update we said that we're more likely to be able to redeploy $150 billion. That remains the target we've got all of 2016 and 2017 to work towards. What you wouldn't expect us to do is to be mechanically redeploying RWAs against a more challenged economic backdrop. One of the concerns I'm sure that a number of people have is about LICs in Asia-Pacific and a deteriorating economic environment. You therefore should take some comfort from the fact that the redeployment in this quarter has been quite modest, but the $150 billion target doesn't change at all.

Iain, do you want to talk about model changes?

Iain Mackay

Absolutely zero came through in terms of model changes in the third quarter. As I've mentioned a little bit earlier, Chintan, the vast majority of what was accomplished in the third quarter was really looking at individual positions on a customer-by-customer basis and across different transaction types, and improving overall granularity of data, whether it was with respect to recognition of collateral and proper matching of collateral types across different categories of assets. But there was nothing coming through in the third quarter in terms of model changes and therefore the changes in risk-weighted assets were a combination of running down customer positions and overall improvement of data quality by those same customer positions.

On trade finance, year over year, nine months we're absolutely flat in terms of revenues generated. And in terms of the margins against that, it's remained largely stable over the course of the same period, Chintan. As Stuart has mentioned, we saw overall volumes declining significantly really from 2013 and through 2014, but we've seen relative stability both in terms of revenue generated and margins against that business over the course of this year so far.

Chira Barua, Sanford Bernstein

One question for Douglas on the domicile - I just wanted to understand what – it's a complicated move; totally appreciate it, but what's taking longer than what he had laid out at the beginning of the year?

The second one for Stuart, generally on repricing across all your liquidity portfolios, given that US rates – who knows whether it rises/doesn't rise in the next two/three years; same for sterling. So, what is the repricing strategy across your excess liquidities that you have both on the consumer book as well as your wholesale book, and where are the areas that we should see that repricing going up?

Douglas Flint

I'm not sure anything's taking any longer. We said in June that we would hope to get an announcement by the end of the year. We're still obviously halfway through that, so we've got another six to eight weeks to go before we get to the end of the year. If we haven't made a decision then because we're still analysing information or the Board wants more, we'll take whatever more time that is necessary. So, I don't think we've slipped, and indeed I don't think that the scale of the challenge or the work is different from what we envisaged back in April and then confirmed in June in relation to the areas that we're talking about. We're taking this very seriously and doing the appropriate amount of work, and it's underway, and we're halfway through.

Iain Mackay

Going back to your question on liquidity, what we have seen within the European environment, particularly looking at negative interest rates – in the interbank space, we have implemented charging for operating deposits sitting with us in the interbank space, and that's been in place now for the better part of the last six months. Broadly speaking, across the portfolio, we're breaking down the overall level of our deposit franchise by type, as you would imagine, and then understanding the underlying nature of the operating deposits that sit with us, both for corporates but also within the financial institutions space. Our principal focus presently is within the financial institutions space and, where we see habitually low and in certain instances negative interest rates, ensuring that we either encourage those deposits to move elsewhere or charge for those deposits. So, in the euro area, it is clear that that is already being done within the financial institutions space. We've not done that in the corporate space at this point and we're looking more widely across the business in terms of where similar practices should be adopted. So, it's an ongoing dynamic review of deposits in general and, where appropriate, either, frankly, encouraging deposits to go elsewhere or pricing such that there is a charge back to customers for us holding those deposits.

Stuart Gulliver

Just one thing I'd add is that the mix of our book is different than some of our North American competitors. So, in terms of volume changes which you might look to see in future quarters, they're not going to be as pronounced as certain of the North American banks, because we have a larger corporate and smaller financial institution mix on our balance sheet than some of the North American banks do.

Chira Barua

That's well appreciated. So, just to follow on on the asset side, is there any big book that you're looking at in terms of repricing in the environment where you have hardly any loan growth right now across the world?

Stuart Gulliver

Part of the whole RWA exercise is underpinned by a target return on risk-weighted assets. So, across Global Banking and Markets and CMB and RBWM, all of the teams are hugely focused on any new business being written at returns on risk-weighted assets to hit those targets and reviewing back books to ensure that actually the fresh business lifts us to an overall return on risk-weighted assets that hits the numbers. So, in CMB and Global Banking and Markets there's a ton of work that's going on as part of the RWA exercise to do just that. What we don't have is a specific book of business which is at miserable returns which creates a portfolio exit type of opportunity. It's a very granular exercise that needs to take place client by client. And of course part of that $400 million that we said we would lose in revenue from GBM reflects exiting low-return clients, because that's how you're freeing up the risk-weighted assets to redeploy them into higher returns.

David Lock, Deutsche Bank

The first question is on the cost-income ratio and the jaws going forward. Clearly, the outlook for revenue has changed since when you gave the Investor Update in June and the cost jaws for this year won't be achieved, but just looking further ahead, if the revenue environment stays weak into next year, is there more you think you can do on the cost side to offset that beyond the kind of things you've already outlined?

And then the second question – if I look on page 8 of your release, it says that capital financing recorded gains from hedging activities, and I was looking in the data pack and I couldn't quite see where those were, so I just wonder if you could quantify those and whether we should expect those to repeat.

Iain Mackay

As I mentioned a little bit earlier, David, the actions on costs within the firm are to achieve positive jaws. That is going to be informed by the revenue-generating capacity of the firm. At this point we've identified 90% of the $4.5-5 billion worth of saves that we've targeted, which, clearly, at June, when we talked about this through the Investor Update, was informed by a particular revenue outlook. The fact that we've identified 90% and are now executing against that – that is good. There's clearly more to be done in that space. However, if the revenue environment is such that more is required to be done in that particular regard, then that's what's going to inform the overall cost position of the firm – the propensity to generate revenues is not necessarily a fixed-dollar target that we established back on 9 June. We're three or four months into this work. We've clearly got a fairly challenging revenue environment in front of us, but we're very focused on a) executing against the cost actions we've already identified and b) ensuring that we've got operating flexibility within the firm to respond to the revenue environment in which we're operating.

Stuart Gulliver

If you take the capital financing question, that relates to basically hedging of credit risk. So, we don't disclose who the names are that we've obviously taken credit default swap protection against, but it's a regular activity that we obviously do and you'd expect us to do. And in fact the gains from that particular hedging appear in the US. So, they appear in Global Banking and Markets in the United States.

Alastair Ryan, Bank of America

Two questions please. One: the margin stopped going down. Is that an indicator it might start going up, or do you have to wait for rates to start moving to get that going? And Hong Kong volumes were quite weak in the quarter, sort of uncharacteristically, and coincident with the slowdown that's going on there. So, is that coincident or representative?

Iain Mackay

On net interest margin, Alastair, I would come back to Stuart's comments of a couple of minutes ago. A significant part of the work that we're doing in terms of return on risk weighted assets and risk weighted asset repositioning is in terms of pricing against client business. So, a significant part of that work is reduction of unprofitable positions with a view to releasing the capital to deploy it into repriced and more profitable business for the firm overall. The interest rate environment we're operating in – although across different jurisdictions policy rates change from time to time outside the major blocs of euro, sterling and dollar and that gives us some opportunity, broadly speaking the revenue environment is fairly challenging for us. An uplift in rates would clearly be beneficial. We can't sit around and wait for that and therefore a significant part of the work in terms of risk weighted assets and return on risk weighted assets is the redeployment of some of that capital into better-priced books of business.

Stuart Gulliver

If you take Hong Kong, Alastair, in the nine months of 2015 the profit before tax of Hong Kong is actually up 6%, and actually it's higher in all of the global businesses.

Alastair Ryan

Volumes, Stuart, sorry. The profits are good, but the volumes, sorry.

Stuart Gulliver

Let's do RBWM first, and then I'll talk about the broader sectors. So, the fall in RBWM revenue from the second quarter is mainly due to the particularly strong equity market performance and the high stock market turnover in the second quarter, and clearly the market was weaker in the third quarter and investor sentiment has been weaker, and that's how you see that kind of drop. So, in Wealth Management products and so on, yes absolutely, demand has softened in the third quarter versus the

second. However, if you look against the prior year, there's still good growth in net interest income from loan growth and actually net fee income in the third quarter was in line with each of the quarters of 2014.

What's generally the case, though, is Hong Kong GDP is slowing and there has been some impact from mainland China on Hong Kong. Retail sales are sluggish in Hong Kong. A lot of retailers are using discounts to maintain volume. The growth in tourist arrivals has continued to slow. And, obviously, since we're all aware of the fact that world trade has slowed up and Hong Kong's a massive port, that clearly has some impact. But as you've seen, we've actually maintained our trade receivables and finance revenue. So, we've grown our market share, which has offset the fall in volumes that's taken place there. So, to be honest with you, I think it's a mixed picture. I don't think you can say with any clarity at this moment that the volumes lead to future drops in PBT, but there's definitely a mixed picture there.

Rohith Chandra-Rajan, Barclays

The first question is just on the RWA reduction. If we look at the analysis of the reductions in the quarter, about half came from exposure reductions and the other half from model refinements and process improvements. And Iain, you mentioned that there has been no sort of model changes put through to date. I'm just wondering how we should think about those kind of main elements of RWA reduction over the coming quarters. It's been fairly stable, actually, in terms of progress in the three quarters to date, so just wondering how we should think about that going forward.

And then secondly, just in terms of the income recognition for BoCom, looking at the carrying value versus market value, if there's any risk to that going forward, or how you perceive that. Thank you.

Iain Mackay

On BoCom first of all, at the half year we had headroom of about $1.5 billion between value in use and the carrying value. That has declined by about 50%, principally because the carrying value has increased as we continue to recognise our share of earnings through equity accounting methodology in the book. So that's down to about $700-800 million worth of headroom. The value in use model obviously is a discounted cash flow model, which is susceptible to growth rates, loss rates, discount rates and such things as we apply to BoCom. To the extent that the value in use remains reasonably stable or declines while we continue to accrue our share of earnings in the carrying value, then clearly headroom is likely to diminish. So, one of the reasons that we continue to provide disclosure around this is that it continues to be a risk to the reported earnings of the Group on a go-forward basis. So it's assessed on an ongoing basis and we'll continue to provide regular updates of that through the quarterly numbers.

As it relates to overall risk weighted assets, again, we've got a target out there of $290 billion reduction by the end of 2017; on an FX-adjusted basis that's $275 billion. We're going to see progress which will not be entirely linear. In the second quarter we saw some significant reductions coming through the incremental risk charge, and that was as a function of reducing some of the positions as it related to the calculation of incremental risk. And another factor that I talked about was just improving the overall alignment of collateral values to individual customer positions and overall improvement of granularity of data quality in terms of recognising by individual positions, for example, residual maturities as opposed to maturity at time of origination, and each of those things has an impact on the credit conversion factors that are reflected within our models. So, although there are no changes within those models approved by regulators, we obviously continue on a position-by-position basis to improve the overall quality, granularity and alignment of the data, and that has helped us realise some of the improvements in risk weighted assets in this quarter.

But I think what you're not going to see is an entirely linear progression against this. When it comes to disposing of positions, that's informed by market conditions, it's informed by readiness of some of the counterparties that we're working with. And Stuart mentioned a little bit earlier how just yesterday we signed a transaction for the disposition of approximately another $2 billion worth of unpaid principal balances through the CML portfolio, which will release a little bit more than $4 billion worth of risk weighted assets. But these are the kinds of transactions that we work on on an ongoing basis, but unfortunately we can't assure absolute linearity in terms of progress against the target, but there's a very significant pipeline of items we're working on here and we're confident of hitting the target.

Stuart Gulliver

I would also like to add that please don't look for it to be linear, because it won't be linear, don't assume that we've just picked up the low-hanging fruit and that from here on in it gets harder. We will deliver the $290–275 billion FX-adjusted – number by the end of 2017.

Michael Helsby, Merrill Lynch

Firstly, you gave us the numbers in costs for Brazil and Turkey in the third quarter. Can you just give us the revenue and bad debt number as well, please?

Secondly, I just want to come back to costs. Iain, obviously you are flexing the costs depending on the revenue outlook, but you hit your $7.9 billion of costs ex Brazil and Turkey in Q3, and clearly that's not that far away from what you're targeting in 2017. There's been quite a lot in the press about what we'd probably call remedial cost savings in the third quarter. Based on your revenue outlook as you exit Q3, is that $7.9 billion a good baseline for what we should expect in Q4 and then again annualising into 2016 or should we be expecting a lower run rate from $7.9 billion?

Iain Mackay

One of the things that hopefully we continue to be very clear about is that we need to continue to invest in this business to ensure the growth of it, as well as recognising that, across many of the markets in which we operate, we've got significant inflationary pressures. Therefore, although we're sitting on that run rate of $7.9 billion ex Brazil and Turkey at the end of the third quarter, we've still got a great deal of work to do in terms of taking costs out of this business and improving the overall operating flexibility and leverage of the business in what is clearly a difficult revenue environment. The cost programme is going to be informed both by the targets that we've already set, positive jaws, and therefore the revenue that the business can generate.

Also as we mentioned back in June we have a continued investment programme in global standards and regulatory compliance more broadly. We don't expect progress to be absolutely linear in this regard, but what we absolutely do focus on and intend to accomplish is a progressive reduction in the overall run rate of the operating expenses on an adjusted basis. I can't say more than that.

Obviously in the fourth quarter, Michael, we've got the bank levy that shows up to kind of stuff up the run rate, but that's something that we split out very clearly for you to take a look at. Our focus is on moving the run rate and the costs down over each succeeding quarter.

In terms of Brazil and Turkey, we will get back to you.

Manus Costello, Autonomous Research

I wanted to follow up first of all on the BoCom point that you made, Iain. I know the capital treatment is somewhat different in terms of the way that you accrue profit into capital but, if you are forced to derecognise BoCom profits, it will have a material impact on your pay-out ratio for next year or indeed this year, if it comes through this year. I just wondered how you would think about that going forward. Would you disregard it and focus on a different version of the pay-out ratio or would you just have to question the progressive dividend policy in light of that?

Iain Mackay

Manus, clearly mathematically there's an impact, because our overall reported profits would be down but, in terms of impact on capital, it is absolutely de minimis. It's actually slightly dilutive to the overall returns of the business. The dividends that we receive run to a few hundred million, so it's not particularly significant from an overall cash flow perspective for the Group. We do not think it would adversely impact dividend flow, so it would have no impact on cash and actually it will have no impact on capital, because we don't believe that the regulatory treatment of BoCom will change, so what we're talking about is an accounting change. If you assess the pay-out ratio from an accounting perspective, yes, the pay-out ratio would go up. However, from a capital impact perspective, it has no bearing whatsoever.

Manus Costello

It feels comfortable, in other words, running with a high headline pay-out ratio if you think it's not significant.

Iain Mackay

If that's the contributing factor, yes.

Manus Costello

My second question relates to your slide on China. Thank you for including this additional details slide 15. You talk about $96 billion of Chinese exposure. Can you confirm; I'm not sure whether that includes the cross-border exposure from Hong Kong. I don't think it does.

Iain Mackay

It doesn't, Manus. What we've included here, as the slide says, is we've included the overall Hong Kong and Shanghai Banking Corporation (HBAP) view in the bottom left-hand corner of that, which is that which sits on the HBAP balance sheet and then we've included that which sits on the China balance sheet. There is a further sum; in total our group exposures to China on a by-country-of-exposure basis is just over $140 billion at the end of the third quarter. What we've shown here is a breakdown of what sits within the Chinese balance sheet, the legal entity balance sheet, and that which sits within the wider Asian exposures, which clearly represents the majority of our exposures to the Chinese market.

Manus Costello

Is that any different from the way that you manage this $96 billion, which is the delta between those two, or do you manage this all on the same basis?

Stuart Gulliver

It's the same people who are managing it.

Stephen Andrews, UBS

A couple of questions from me please. Firstly, back on the Asian retail business, I think everyone was expecting GBM to be weak and a certain amount of weakness in Asian retail, but it is quite a bit weaker than what we were looking for. From what you were saying earlier on, it does sound like there were some one-off mark-to-market impacts in the insurance and life business. Can you just quantify those for us? From the numbers, it looks like it could be a couple of hundred million or maybe $200 million or $300 million that could be material. That may not repeat as we go into Q4.

Iain Mackay

Yes, the impact coming through Retail Banking and Wealth Management, the insurance business, in the third quarter is the flow-through of the valuation to those policies that we've got with customers where there are discretionary participation features. It's about $214 million of impact in the quarter.

Stephen Andrews

We shouldn't expect that to repeat, so that should just pop back to zero.

Iain Mackay

It is a function of the valuation of the stock market so, to the extent that we've got stability in the stock market, then I think it would be fair to assume it doesn't repeat. If you were to see a significant uptick, we'd get somewhere from it. If you saw a significant downtick, you'd get another adjustment to that, so it's very much related to the performance to the equity market.

Stephen Andrews

The second question I've got is just a point of clarity really. In the adjustments this time, we've got this $165 million cost to achieve that's popped in related to your restructuring. Then on your slide 5, you've

also got your Change the Bank, the $952 million in the sort of core costs, if you like. I imagine that $165 million is probably going to get a lot bigger as we go into next year, on a quarterly basis. Can you just give a bit more clarity on what's going into the $165 million and what's going into the $952 million?

Iain Mackay

To be clear, the basis of presentation here is the adjusted versus reported and there is extensive detail provided on what the reconciliation between the two, in the appendix in the presentation. If you want a little bit more detail in that, I'm absolutely happy to take you through that detail. In terms of the cost to achieve, perhaps the closest approximation I would give you in accounting terms is restructuring charges. To the extent that we do reductions in force, for example, to the extent that we do elimination of some of the programmes, one of the examples that Stuart used earlier was the elimination of certain software applications, which we're doing through our operations team. The extent to which there's any software that's been capitalised sitting in our balance sheet, a write-off of that, for example, would fall within the costs to achieve. To the extent that we terminate leases in any of our facilities around the world, as we resize the footprint for the group that would fall within the costs to achieve.

What we've done across the cost base is to show what is Run the Bank, so basically showing up, switching on the lights each day, people showing up to work and running the place, day in, day out. That's Run the Bank and we've obviously split that in terms of front office and back office. In terms of Change the Bank, it is the ongoing investment in the improvement in the operating capability, whether it's expenditures to update operating systems through the regulatory compliance space, through the financial reporting space, through the credit management space, through the customer service space. The Change the Bank is just the ongoing evergreening of the organisation and normal investment that we would make to improve the operating efficiency of the bank. The cost to achieve should more appropriately be described as restructuring charges, and what you would normally see falling into the cost to achieve are restructuring-charge type expenses.

Stephen Andrews

Okay, thanks, so they're similar to the $117 million of restructuring and other costs. We could just lump those two together. On your slide 16, you've got the cost to achieve and then restructuring and other related costs.

Iain Mackay

Yes, that's correct.

Stephen Andrews

Is it those two together that were the $4 billion costs to achieve in total? Is that fair to say, which you laid out at the strategy day?

Iain Mackay

No. The cost to achieve that we set out was $4-4.5 billion against the overall cost reductions of $4.5-5 billion. That's the cost to achieve. That's in the report.

Ronit Ghose, Citigroup

I just wanted to look back at asset quality. Obviously your LIC charges this quarter were generally low, with the exception of the UAE. Is there any colour you can give us on balance sheet asset quality trends or any numbers, for that matter, in terms of particularly in Asia what you're seeing in Q3 versus Q2, either in numbers or qualitatively, please. On the Middle East, is this a couple of businesses in the UAE in the mortgage book or do you think there's more to come in the general region, in your MENA portfolios, for higher LICs ahead?

Iain Mackay

In terms of MENA specifically, we've got an adjustment to the overall provisioning level for the mortgage book where there is, at an industry level, some issues with respect to perfecting collateral, with respect to the mortgages. What we've actually done is provide for that portfolio as if it were an unsecured personal

lending portfolio. Whilst at the same time clearly doing the work to try to improve the overall quality of documentation and perfect collateral, our view is that this was a one-time adjustment to reflect that.

Then we had a couple of individually assessed credits within the United Arab Emirates, which are not particularly related to any individual sector. It would be fair to say, when you look at overall exposure to commodities and specifically oil and gas, there is a heightened level of monitoring coming through the risk teams looking at the impact of lower oil price over an extended period of time. Although we're not seeing credit costs coming through to any significant degree in that sector presently, clearly Middle East and North Africa, with their concentration of oil-producing countries, are places that we'd look a little bit more closely at and keep a very close eye on. These were really just two individually assessed credits that were subject to adjustment at the third quarter.

Ronit Ghose

Could you just comment a little bit further just switching to Asia? Are there any clear balance sheet trends and is it possible to give us the numbers in future, the 90-day overview or any kind of balance sheet impairment number?

Iain Mackay

The information that we provide in terms of loan impairment charges trended out over an extended period of time provides a reasonably good illumination of what's emerging in terms of credit quality. Clearly from disclosures that we provide at the half-year and the full year, it breaks down the overall allowance against the loan book across the different geographies. That disclosure will clearly be there at the fourth quarter again.

The overall asset quality across the portfolio, with the exception of the Middle East and North Africa that we just talked about, is remaining very stable. You saw loan impairment charges in Asia trend down very slightly in the third quarter. North America ticked up just a little bit and that was more a reflection of the fact that we had releases against the CML portfolio in the same quarter last year, versus smaller releases in terms of that particular book of business this year. We've seen overall credit quality in Europe and the UK remain very stable to improving slightly, and certainly in Latin America we saw some improvements in credit quality. Again, that's largely reflective of the fact that the third quarter of last year was slightly heavier from a provisioning perspective, particularly in the commercial banking space, when we looked at the homebuilders in Mexico.

I think, when you look across overall asset quality by the main regions in which we operate, the quality remains very stable. There is in this environment, as you would expect, a heightened scrutiny and review of assets but what we're moving on to watch and worry lists within the quarter has remained fairly stable.

Ronit Ghose

That's really clear. I should say, compared to five or six years ago, your disclosure is very helpful in than it's actually much easier to track your bank than it used to be. This is not meant as a criticism. In the next year or two, you're going to get so many more questions on the asset quality side. You could just pre-empt them by giving us more balance sheet disclosure quarterly, but it is a lot better than in the past, so thank you for your comments today.

Martin Leitgeb, Goldman Sachs

Just one follow-up on asset quality to start with: I was just wondering whether you could comment on asset quality trends, as you have seen them within your commodity book over the quarter. Then more broadly on the UK ringfence, with the consultation paper, I was just wondering whether your cost estimates with regards to setting up the UK ringfence have changed.

Iain Mackay

On UK ringfence firstly no change. We set out an estimate of between $1 billion and $2 billion. That remains the expected range to implement the ringfenced bank. The consultation document that came out a couple of weeks ago has not changed that at all. The reason for the width in that range is frankly just given the complexity from an operational perspective, particularly when focused on separation of technology between the ringfenced and the non-ringfenced bank, and then the impact in terms of

sort-code alignment between the ringfenced and the non-ringfenced bank. But no, overall that programme continues to progress well.

Stuart Gulliver

If you're asking, Martin, in terms of the concerns we had about whether it made sense for us to own the ringfenced bank, the recent speech that Andrew Bailey gave at Mansion House has dealt with our concerns very satisfactorily, where he indicated that the ringfenced bank's strategy, risk appetite, CEO and indeed dividend would all be available to be controlled. The dividend is obviously subject to PRA satisfaction about the amount of capital that the ringfenced bank has been holding. It would then be able to dividend back up to its parent. The strategy and risk appetite of the ringfenced bank would be able to be controlled by its parent and the CEO of the ringfenced bank would be able to report to both its board, but also its parent. Those concerns that we had about whether we would effectively be an asset manager of the ringfenced bank, i.e. just an equity owner, have been dealt with completely satisfactorily by the remarks made by Andrew Bailey.

Iain Mackay

Going back to your commodities question, the exposure to commodities within the group has remained very stable over the course of the last couple of quarters. We've had one or two additions to the watch and worry list, but even for those we're very close to the customer; we're reasonably confident about the overall quality of that book. When we look at the group's overall exposure to commodities, it's a very, very small proportion of the overall balance sheet, but again it's an area which, as I think everybody would rightly expect, gets heightened scrutiny and monitoring from our risk teams around the world.

Chris Manners, Morgan Stanley

I had a quick question for you on capital, if I may. Good capital build in the quarter; another 20 basis points, taking you to 11.8%. That means you really are almost knocking on the door of your 12% to 13% range. Just maybe you could share with us where in that range you would like to be. I suppose the growth opportunities maybe aren't quite as good as we'd hoped in June. Is there opportunity for capital management if you get above that 12% or are you going to be able to build into 13% on the basis that we think that fundamentals with your trading book and operational risk, and the high hurdle in the stress test and all that sort of stuff might put you towards the top end of the range? It looks like you're almost there; I'm just trying to work out where we would want to sit in that range.

Iain Mackay

Really no change in terms of guidance versus the last time we spoke on this, Chris. No particular urge to be at the top end of the range, but certainly we'd like to be above the bottom end of the range. I think many of you have commented accurately that, on a pro forma basis, the disposal of the Brazilian business would take us into the bottom end of that range. Based on this quarter's close-out, it would put us round about 12.2% to 12.3%. Frankly sitting somewhere around the middle of that range, we think, given some of the prevailing uncertainty within the regulatory space, is the right place to be for the moment.

To the degree that that uncertainty hopefully clarifies over the coming months, and we would expect to hear a little bit more about the fundamental review of the trading book by the end of this year, the time of its implementation and what that implementation would be still remains very unclear. Equally unclear is the situation on operational risk, which we've seen move back a little bit over the course of the last few weeks and obviously a revision to the standardised approach we also see being at 2018 and beyond, and certainly the outcomes of it being very uncertain at this point in time. Notwithstanding the fact that the teams have done a great deal of work modelling out what the different consultations and QISs have alluded to, in terms of providing meaningful insight as to what the implementation would mean for the group, it's too early to say.

Chris Manners

If we build to 12.5% pro forma and then we don't get the growth opportunity that we were hoping for from the Pearl River Delta and ASEAN, etc., then what do you do? You would either continue to build capital above the midpoint of your range or give it back. I was just thinking about how that works. It looks like the trajectory that you're on is to actually build through 12.5%.

Iain Mackay

I think we'll cross that bridge when we come to it, shall we? I think what we've laid out today, Chris, is that we remain committed to realising $290 billion worth of saves from risk-weighted assets; as Stuart mentioned, committed to redeploying the capital associated with those $150 billion plus of risk-weighted assets into higher-returning businesses between now and the end of 2017. We're very focused on managing down the overall cost position of the group and creating greater operational flexibility in that regard. If that all adds up to higher capital position, then we will address that through distributions to shareholders, as and when regulation provides clarity and obviously subject to approval from the PRA.

Stuart Gulliver

The way we've constructed this is to get an RoE of 10% with a CET1 between 12% and 13%. You'll have seen in this quarter that we had a return on equity of 10.7% and a CET of over 12%. Between 12% and 13% or right up to 13%, we're still trying to run the business so we've got an RoE of 10%, if we're sitting with a CET1 of 13%. As Iain says, of course it depends on what the regulatory environment is. It depends on our opportunity to redeploy and, if the regulatory environment is as it is and there isn't an opportunity to redeploy, then we will return it.

Chintan Joshi

Just quickly on slide 6, going back to the costs, you've shown us $30.2 billion rebased cost in 2014 and, if I look at the current run rate, you're running at $31.8 billion. That's a 5% increase. I'm just trying to split this into cost inflation and other items like regulation that you call out, from time to time. I just want to get a sense of what is underlying wage inflation here. Hopefully it's coming down, due to the kind of environment we're in, but still it looks like 5% increase. I'm just wondering what wage inflation there would be.

Iain Mackay

For the nine months, the overall inflation that we calculated was about $500 million on a nine month over nine month. The significant majority of that is coming through wages.

Stuart Gulliver

Okay, thank you very much. That brings the call to an end. Thanks, everybody, for joining the call.