Edited transcript

Post-Annual Results 2013

Meeting with Analysts hosted by Iain Mackay, Group Finance Director

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Corporate participants:

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Nick Collier

Welcome, good morning everybody. We have callers on the line there. They will be listening, but at some stage during the proceedings we shall let them in. Normal rules apply, so please, before you start speaking, asking your questions, if you could mention your name and house, and make sure you have always got a microphone when you are speaking. I would very much like to introduce Ian Mackay, who is familiar all of you – Group Finance Director. With him we have Russell Picot, who is Group Chief Accounting Officer, to his left. To Russell's left, Jane Leach, who is the Head of Regulatory Reporting. Also to the right of Ian, we have Rob Irvin who is Head of Group MR. Without further ado, over to Ian, who is plugged up.

Iain Mackay

It has been an interesting week; it is not over yet. As far as my week is concerned, it probably won't end until about seven o' clock this evening. Hopefully you have had a chance to work through the numbers now, although there has obviously been a lot going on this week. I am very happy to take any and all questions from you. As Nick pointed out, we do have Russell, Jane and Rob here, so… Wow, that is really loud. Is that better? Okay, thanks. So with that, there's probably one or two things that, as we get through it, if the questions don't come up I will provide some clarification around one or two points which perhaps weren't picked up as clearly as we wanted them to be on the Monday discussion. But we will wait to see whether those questions come up, and if not I will address them before we finish up in an hour or so. Okay, so with that, I am happy to throw it open to questions.

Mark Phin, Keefe, Bruyette & Woods Limited

Good morning. It's Mark Phin, KBW. I am just trying to understand – I think I am probably being a bit thick – on BoComm.

Iain Mackay

Okay, well that's one point I wanted to raise at the end.

Mark Phin

I understand, first of all, the impairment test, and the reason for the impairment test, etc, but what I do not understand – you've got about 600 million headroom to the value in use. That value in use, presumably, just unwinds to the extent that the discount rate unwinds, which is going to give more headroom in – for profit recognition for this year. So I am, kind of, just trying to understand why that profit derecognition actually happens.

Iain Mackay

But understand also that we add carrying value every year to the extent of the profits recognised from BoComm. So, under the associate account then we pick up our share of net assets, and the net assets are added to by the accruing of profits within BoComm. So our share of BoComm on an annual basis tends to be between – well, certainly last year it was about 1.9 million. So when you think of that headroom of $600 million, our expectation is, barring a very, very substantial change in the value in use – which we do not foresee – you know, as you can see in note 21, we have laid out a number of scenarios that would alter the value in use of that model. Clearly the value in use will change progressively over time. Some of those assumptions would change as economic conditions might change. But what we know will happen is that we will – BoComm continues to be a profitable business; it generates profit, it continues to grow its balance sheet. Our view is that it is a reasonably well risk-managed business. But our carrying value is 13.4 billion. Our value in use model suggests 14 billion. We have got headroom of 600 million. Under normal circumstances, we would pick up our share of their profits – our 19.03% share of their profits – on an annual basis. So round about the middle of that year we expect to get to the point that that headroom – although we will continue to assess it – that that headroom will be gone. The point at which that headroom is gone, then we would in effect continue to recognise profits, but we would make provision for the fact that we are now in excess of – our carrying value would possibly be in excess of value in use, which under the accounting laws, we can't allow to happen.

Mark Phin

Okay, so the way the value in use – the assessment of the value in use was 14 billion, moves from here. Is it too simplistic to think that that just – there would be an unwinding of the discount rate of the 13% that you state in the accounts, or –

Iain Mackay

Well, no. It's a continuous model, so it doesn't – I mean, you – this is not quite in perpetuity, but this is a long-term cash flow view. It is based on the profits, the cash, the growth factor, the losses that would come through BoComm's financials, and a discount rate, which is a market discount rate that would apply to that profit stream. So it doesn't unwind. There is not an unwinding component. We would – so, as we reassess this at the first quarter, the second quarter, and so on and so forth, we will reassess the terminal growth rate, we will reassess the actual performance of BoComm, we will reassess the dividends, we will reassess the loss rate, we will reassess the discount rate. But barring significant changes in those assumptions, we would expect that value in use to be reasonably consistent with how we have assessed it at the end of the year.

On the basis, we would expect the carrying value, which does change based on our share of pickup of profits on an ongoing basis – is that we have got a reasonable expectation that by the mid-year, our carrying value will, in all probability, exceed the value in use. At that point, we would have to make provision for the difference in that carrying value and value in use. Now, the way that would change is that if the market value were to change significantly – but I think with some of the noise around emerging markets at the moment, and perhaps mainland Chinese banking or the financial system as a whole – I'm not sure it's fair to say banking, but the mainland financial situation as a whole – the likelihood of the market value of this changing dramatically between now and the middle of the year is probably somewhat limited.

Mark Phin

Okay, understood.

Iain Mackay

So in that sense, what we would therefore expect to see is, on a net net basis – I mean, this is not exactly how the accounting works – but on a net net basis, we have got about half a year or so's worth of profits from BoComm at risk in our plan.

Mark Phin

Okay, understood. Then, from a capital perspective – I am just not sure I understood the way that works through. Is there something to do with the deductions that makes it capital-neutral, or… Just trying to understand.

Iain Mackay

So today, the way this is – there is a proportional consolidation for regulatory capital purposes, which is obviously not entirely consistent with an equity method of accounting. What we've got in process are discussions with the PRA – is to reflect more accurately, to try and get a symmetrical treatment around the treatment of BoComm, such that it would no longer be proportionately consolidated, but conceivably treated within material holdings threshold.

Russell Picot

Okay, and just to be clear, just can I maybe amplify that? So the regulatory treatment is, we take our share – broadly 19% - and we bring into the regulatory balance sheet a 19% share of BoComm's balance sheet and then risk-weight those assets. That process takes the acquisition goodwill and deducts that fully from capital, so on a regulatory capital basis, it's – that goodwill's completely written off. So the regulatory routine that's running is that we would still pick up our share – our 19% share – of their profits, without – so the group CT 1 capital will still accrete profit share as we will also reflect our share of their RWA growth.

Mark Phin

Okay, thank you very much.

Iain Mackay

Okay, next question. By the way, as we go through this, anybody in Hong Kong please feel free to shout up if you have got questions, okay? Yes, down at the end, Alastair.

Alastair Ryan, Bank of America Merrill Lynch (UK)

Sorry, I found the last seat in the house. Just to follow up on Mark's question then. So when you are paying your dividend, BoComm didn't really – I mean, it was 500 million or so contribution in cash to the group last year because you got a dividend in, which was a small proportion of the earnings that you were consolidating. So when you are thinking about your dividend for this year, assuming that this thing does happen, and you're not getting the BoComm profits and the P&L, what do you think about – how do you think about payout ratios? I mean, do you –

Iain Mackay

Well, it doesn't – I mean, a little bit depends – although a very little bit depends – on whether BoComm continues to pay dividends. I mean, certainly in our interaction with BoComm – notwithstanding our accounting treatment of this Alastair, which we've gone through with the BoComm leadership, so that we're all, sort of, on the same wavelength with respect to this – as you can well imagine, the response that you get from BoComm is, 'Well, we continue to grow, we continue to be a profitable business, we continue to pay dividends.' You know, there is certainly nothing in our outlook that would change that. So we would expect them to continue to pay dividends.

Alastair Ryan

No, but it's – sorry, your dividend not theirs. So –

Iain Mackay

Well, but again, my dividends are reflected largely as – the degree to which we depends on the profits from BoComm to inform our dividends is very, very small. It's a reflection of our distributable reserves; it's a reflection of the profitability of the businesses owned and controlled by HSBC; the ability of those subsidiaries to flow dividends to us – so, HBAP, HBEU, the Mexican business, clearly not the US business, the Canadian business – to flow dividends from their profitable activities, their self-capitalisation, their surplus capital – back to Holdings; and our overall distributable reserves from Holdings, which are very substantial, which funds dividends.

Alastair Ryan

Does your regulator understand that? Because the evidence over the last couple of years is that that wouldn't necessarily be the case.

Iain Mackay

You're just trying to wind me up, aren't you!

Alastair Ryan

No, no, it's important, because if you end up with a dividend policy that's appropriate for HSBC, based on what you've just described – if you are not accruing for the BoComm profits anymore because this latest way of changing your reported profitability, then it looks like you've got a higher distribution than you otherwise would have. The regulator seems quite focused on percentage distributions of reported profits.

Iain Mackay

Do you think that is the case?

Alastair Ryan

Yes.

Iain Mackay

So, since this meeting's not about Barclays – but if you would apply the Barclay's scenario to that, do you really think that's the case, Alastair?

Alastair Ryan

Yes, based on my discussions with the regulator and with other banks, one of the key considerations the regulator has – along with a long list of others – but one of the key considerations is percentage distribution of the reported profits.

Iain Mackay

Right, so, fair enough. But I would also say that – you know the pie chart that we put out – the, sort of, targeted 40, 45, 15, that's out there?

Alastair Ryan

Yes.

Iain Mackay

Our regulator is very happy with that construct. We have, I think, over the last few years, put together a distribution framework, and lived within that distribution framework, with which our regulator actually is very happy.

Alastair Ryan

But again, that framework implies – so BoComm's 8% of your profits.

Iain Mackay

Yes.

Alastair Ryan

So if it's not 8% of your profits any more, it's gone, your profit's gone down 8, so that pie chart has got smaller – which is different to what you've described about how you actually pay your dividends, which is about the cash earnings from the cash subsidiaries, and the cash flow within the group – which is a robust way of paying it, but is constructed differently.

Iain Mackay

I mean, there's no precision around that pie chart. It's a framework, which, by the way, is a framework that no other bank on the face of the planet seems to adhere to. We've got a very strong, profitable business model. I mean, if you want to look at the returns from BoComm, the returns from our risk-weighted asset bases from BoComm are very, very slightly dilutive to the returns on risk-weighted assets of the group overall, and I mean slightly dilutive. But they are dilutive. So, in many respects, the exclusion of that, to the group – although from an absolute dollar number of the pool that you might consider in respect of any year for distribution, before you even consider the overall distributable reserves for the group, may reduce that pool by 8%, as you would say – in terms of that having any significant impact on our ability to live within 40-60% distribution, within the framework of 40, 45, 15, I have absolutely no concerns about that whatsoever. If the PRA have any concerns, they certainly haven't raised them in discussions we have had with them around distributable profits.

Alastair Ryan

Okay, sorry, and last, before I completely finish bludgeoning myself on this topic – but at the 40-60%, in theory, if you are paying the dividend the way you've described – which is the way that the group's paid the dividends historically – and then BoComm drops out, your target range moves up from 40 to 60,

because a non cash-flow piece of the profits disappears from the profits. So that's my question, which I've asked poorly.

Iain Mackay

Yes, maybe, but it is marginal, Alastair, you know. BoComm's not 20% of our profits. It's less than 10% of our profits, so if it's got a couple of percentage points' impact within the 40-60% range, it's not going to put my nose out of joint, and I doubt it will for the PRA.

Alastair Ryan

Thank you. Who's next after that?

Russell Picot

Alastair, maybe just to reinforce the point – I mean, because that accounting process doesn't inform the level of CT 1, that's one reason why that dividend payout ratio shouldn't be a regulatory issue, yes? I understand the accounting measurement.

Iain Mackay

The proportionality, yes.

Russell Picot

And the payout ratio. On those nominal terms, you are quite right; that could nudge upwards. But if you think about the cash consequences, no change, Holding company's got a touch under 50 billion distributable reserves and the Group's regulatory ratio – CT 1 fully loaded – is not changed by that accounting routine. So the fundamentals, we think, aren't changed. We accept the accounting point, which is – clearly we've been signalling.

Iain Mackay

Yes, Tom.

Thomas Rayner, Exane BNP Paribas (UK)

Could we just come back, then, to the CT 1 – slide 15. I know you've talked about it on Monday. I'd like to understand a little it better the – you know, the floors the PRA is talking about – whether there is anything else of that nature that might be a risk factor, going through this year. Also, the uncertainty around some of the other issues that – you know, you seem – maybe you are the only bank being totally straight about this, but you seem to be more uncertain than some of your peers about these issues. So I wonder if you could, sort of, talk about the bullet points on slide 15 in a bit more detail and, you know, where do you think your fully loaded needs to go to over a, sort of, three to four year time horizon. I know transitional gives you out to 19, but again, I wonder if in your real planning you give yourself that much time.

Iain Mackay

Well, I'll give you a few thoughts on the comments on page 15, and then perhaps Jane can take you through a little bit more on – specifically the topic on the floors that will be – that we expect to have applied to certain of our corporate portfolios. But, the uncertainty has got no worse than it was six or nine months ago, but nor has it got any better in my view. There are – the ongoing process of ITS and RTS being promulgated by the EBA moves ahead. I mean, we are not led to believe – the PRA – not the PRA – the EBA's been very clear that that's going to take most of 2014, and possibly even into 2015, to complete that process of promulgating the standards, having those standards consulted on – some of them will probably go through a consultation process, as some of those that are already approved have done in the past – and then the interpretation of those at a national level, and the application of those at a national level. So that's just a fact. So there is still a substantial number of the rules and regulations, with respect to the implementation of elements of CRD IV, which do not exist. So that, in and of itself, provides some uncertainty.

If you want to then take the view that how those would be defined by the EBA, adopted by the Commission – and then, another extra unknown factor, how they would be implemented and applied by the PRA – in my view, and certainly all the evidence hencetofore would suggest this is the case, that the PRA has tended to adopt a super-equivalent attitude to virtually everything they've done under the construct of CRD IV, whether it is with respect to capital or liquidity. So that's a second element of uncertainty.

So it's the promulgation of rules, the interpretation and application of those rules on a national level. A third element here, which again sits within the CRD IV, is the definition of the leverage ratio. So, the published ratio that we provided was not that envisaged by CRD IV; was not that envisaged in Basel III at the end of the year; but was a hybrid of an interpretation that the PRA provided to us, which is the published basis. So again, how that is defined – so we got guidance from Basel III. That will then be reflected in CRD IV guidance as to how it is to be adopted in Europe, just as the Americans are going through a similar process as to how it may be adopted in the United States. Then there will be an element of implementation within the United Kingdom. So again, within the United Kingdom, for example, the PRA could take a CRD IV application and then say, 'Oh, and by the way, we then want to slice off that, from a capital perspective, the FPC adjustments which they pushed through last year in terms of assessing Common Equity Tier 1' – as an example, or an area, of uncertainty.

Another area of uncertainty is when you go into, how do we develop the ring-fenced bank, and what is the guidance that the PRA,ow that they have got the legislation in front of them, as they develop the regulations for the implementation of the ring-fenced bank, then what does that mean – principally with respect to the structure of our businesses in the United Kingdom: the capital requirements and, as a component of those capital requirements, the leverage ratios that may apply to the UK bank – which would then define the sorts of activities that we could do, or would want to do, focused on the profitability of the organisation within either the ring-fenced bank or the non-ring-fenced bank within the United Kingdom. What is clear is that there will be a ring-fenced bank. What is considerably less clear is what activities will be permitted, or required, to be inside that ring-fenced bank, and those which would be permitted, or be required, to be outside it.

So those are uncertainties which have existed for some time. We hope, we have an expectation that as the year progresses – but it is the year; it is not the quarter, it is not the half year – that some of those uncertainties will be removed. But a key element, in terms of us being able to plan where we think our long-term core capital requirements are, is how the PRA will adopt those and then implement them within the construct of the consultation document they put out at the end of last year around the implementation and the interaction of buffers. So, whether it is G-SIFI, whether it is counter-cyclical, whether it is sectoral capital requirements, or whether it's this PRA buffer – call it Pillar 2A, Pillar 2B, or some other definition thereof – and how it would interact with the other buffers that would be implemented.

The PRA have not provided, other than in the consultation document – which I think we would probably all agree wasn't particularly definitive – have not provided guidance on how that is to be implemented. Now, some of our peers in the UK market have clearly defined some assumptions about where they think they need to end up. But we do not believe that has been based on any particular guidance that they've received from the PRA. We don't know because there are clearly confidential discussions going on between the regulator and individual institutions. But what I can say categorically is that the PRA have not guided us to any end-point requirement from a Common Equity Tier 1 under Basel III. What I – you know, the guys that have gone out there and picked a number – you know what, they may well be right. They may well be desperately wrong. What I don't want to do – what we do not want to do as an institution – is put a number out there that then the PRA – that guides the PRA to that point. If we believe, as we do, our target of 10% or greater – and by greater, we don't mean 10% greater, we mean a point or so – is more than sufficient to the risk profile and the risk management appetite of this group, then what we don't want to build to is 12, 13 or any other percentage point because we think more is better – because we think we are extremely well capitalised at the moment. Our regulatory capital requirements are almost twice our economic capital demand. Therefore, I'm not going to – we're not going to put a number out there for you, on the basis that I don't particularly want to guide the PRA to a higher number than we think is appropriate to the risks we take in the group.

Thomas Rayner

Okay, I hear you on that.

Iain Mackay

But your frustration around getting a number and plugging it into your model, I can assure you is amplified several factors over inside this institution around what we can do in terms of planning long-term, both in terms of specific investment within the group, but also providing – to the extent HSBC ever would – greater certainty to you about our deployment of capital; whether it is inside the group to grow returns, or whether it is externally to the shareholders in the forms of dividends or conceivably neutralising scrip in the future.

Russell Picot

If I may, Iain –

Iain Mackay

Go ahead.

Russell Picot

Just to provide reassurance – I mean, these disclosures faithfully represent the bilateral contact and meetings we have had with the PRA, as well as our participation at very senior levels in industry-based discussions with our regulator on this matter.

Iain Mackay

I mean, if you go through Pillar 3, there's about as much guidance – I mean, that – to Russell's point, it is a very faithful reflection of everything that we know at this point. So we're not playing any hide and seek game with you here.

Thomas Rayner:

No, I hear you. But, I mean, if you take the final paper – because the consultation paper didn't become a final, sort of, paper – the things we know – that if you think about the things we know for sure – 4.5% equity for Pillar 1, 2.5% capital conservation buffer, 2.5% for you for SIFI – It's 9.5%. We know there's going to be something for Pillar 2A. I would guess a per cent. Maybe it's less, but I would guess – that's 10.5% before we even talk about capital conservation or other scalars and add-ons. 10.5% looks like going to be the hard floor where distribution restrictions kick in. As a management team, you are going to have to run at a premium to that, because you can't control the ratio within a certain amount because of market volatility. So I would have thought that go to – and I'm not saying when go to is – would be minimum 12%, and possibly even higher than that figure.

Iain Mackay

So how would you triangulate the comments from the American banks over the course of the last ten days? So Citibank is looking at 9.5%, Wells at 10%, JP Morgan at 10%. You know, the French banks making noise about 10%. So the question here – you know, capital conservation's already in that 9.5%. G-SIFI is already in that 9.5%. The core requirement's already in that 9.5%. We are sitting at 10.9%. If you take the floors that we've talked about as the starting point, we're sitting at 10.6% as a starting point for January 2014. Last year, net of dividends we generated $10.1 billion worth of capital. Regardless of what the end point is, Tom, our ability to get there through the profitability of the group, over any reasonable period of time, and preserve a progressive dividend, we are very confident about unless, of course, they come out with something truly outlandish. If they do come out with something truly outlandish, then we've got a whole different set of issues about the competitiveness of the UK banking sector, with Americans who seem – who knows – I mean, again, some of these banks have been through CCAR a couple of times. We are literally going through CCAR the first time around. We will hear from the Fed towards the end of February on that point. But these discussions are confidential, but to the extent at which, you know, three of the largest American banks – two of which we compete with actively in global markets – are indicating that they believe their end-point Common Equity Tier 1 needs to be somewhere between 9.5% and 10.5%.

Christopher Wheeler, Mediobanca Spa Yes, but Iain, I have followed JP Morgan, and looking at the numbers they present – it is pretty interesting what you say about JP Morgan because if we go back three years, Jamie Dimon was calling Basel III un-American, and then suddenly he got this light on the road to Damascus, when suddenly he said, 'I want to get to 9.5% very, very quickly'. If you look at the slide they put out – and the *FT* has labelled it with this wonderful headline, '30 billion war chest', which was complete nonsense, because all it was showing – because they now have no idea, I think, and they are getting very nervous about the Fed – was saying, 'We're just going to show you, based on 9.5% or 10.5%, where that capital goes, and that 30 billion was on, we may be on 11.5%'. I think their worry is, they may not be able to operate off 9.5% or 10%, because what is happening after these CCARs is that each time, they are saying – the Fed is saying – 'Just wait a little bit'. That, I think, is the thing. That's my worry, that you're getting – they're coming after you.

Iain Mackay

There are other factors in there though. If you think about the number of basis points that they get carved off their Common Equity Tier 1 as a consequence of CCAR a couple of years ago – it was 350 – 330, 350 basis points. So when Marianne talked about this on whatever day – is it Tuesday this week – or Tuesday, Wednesday this week – she, sort of, went through how she'd built up to, or how the firm had built up to, that number. There's some pretty good logic behind it. Now, if the new CCAR slices five points of, well, you know, that argument goes out of the window. But, I mean, you see the weighting on operational risk, that all the banks are picking up as they move to Basel II under AMA. I mean, two and a half to three times operational risk capital requirements. But again, that is factored into the ratios. All I'm saying is that what we have to work towards as a firm, and hopefully as an industry in the UK, is ensuring there is a capital management framework that allows us to remain reasonably competitive on the international stage.

Jane Leach

It's worth remembering, from the PRA's perspective, that it's not just that they haven't set the buffers yet; they have not even set out the framework for assessing the buffers. They – you know, really we would be guessing, really.

Christopher Wheeler

No, I am just making the point that I think that these guys have been – they've been following – or, particularly the UK banks, perhaps, the European banks – in terms of saying, 'No, no', and then saying, 'Oh, hang on a minute'. You are seeing it then being pushed up in a very similar way. So in some respects, the uneven playing field may actually become more even because I just don't think the Fed are letting them be as aggressive they had hoped they would.

Iain Mackay

It may indeed. But then, I think, as we talked about on Friday, you know if we – not on Friday; Monday – if we end up – I think one of you asked the question about, 'Right, if you're sitting' – 'If your end point ends up being 12-13% Common Equity Tier 1, then really, can you achieve 12-15% return on equity?'. Stuart's answer was right on the money; if we were to achieve that, then the return on risk-weighted assets ranges that we've set for our business needs to move up. We certainly would need to be operating at the very high end of those return on risk-weighted ranges, because the lower end of those ranges correlate to 12%. The higher end of that ranges correlates more or less to 15% – or certainly above the mid-point of the range. If you end up – and that has always been; the consistency with which that's modelled has never changed. It has been based off having a Common Equity Tier 1 ratio of greater than 10%, but certainly not 12% or 13%.

So there is – that is the uncertainty we are dealing with. It has not got worse. There's a time framework here, through which the PRA needs to set out it's framework for capital management, the implementation, and the interaction of those buffers – and, notwithstanding the consultation document, that work hasn't proceeded.

Russell Picot

When we get there, there are also the areas of uncertainty to do with the FPC, and sectoral-specific requirements – a different landscape.

Iain Mackay

Yes. But it will be – yes. I mean, the Americans, again – whether it is bluff or not, they are out there saying, 'Look, countercyclical is going to be zero for the US'. Where the US economy is at the moment, you couldn't even conceive of anything being more than zero, right? There's a similar argument to be made for the UK – certainly for Europe. The challenge, of course, I think – which is Russell's point – is, sectoral capital requirements – the question which becomes very political is if you get a real broad-based housing boom in the UK with the FPC coming in to say, 'We need a sectoral capital requirement in UK mortgages'. That wouldn't necessarily be a countercyclical buffer, but then, how would they apply – now, politically, that is a hot potato of the first order. But that, conceivably, is what a sectoral capital requirement is for: a particular sector is overheating; we need to cool down credit supply in that area, tighten capital requirements, make it difficult for banks to generate attractive returns on it, switch off credit at the source.

So the tools are there, and we would not disagree with the necessity for those tools to exist. But I think what we're all working towards is – and perhaps there's an element of hope associated with this, which isn't a great strategy – is that the intelligence and thoughtfulness with which that will be applied by the FPC and regulators in general will be well thought through.

Russell Picot

He is optimistic.

Christopher Wheeler

Well, I mean, obviously the worry is that the FPC has a great model in FINMA, in saying, 'Chaps, your mortgage weightings are going from 12% to 30% in the next five years. That is a worry, I guess'.

Russell Picot

Well, I mean, that wouldn't fall evenly on all the UK banks, dare I say – which they will be aware of.

Christopher Wheeler So just on those floors –

Russell Picot

So Jane, why don't you talk about those floors a little bit?

Jane Leach

So, yes, I mean, on the floors – as I think was explained previously – this is about the – essentially the PRA's exercise around low-default portfolios, and portfolios where there's not sufficient data, in their view. So they've been working with us around the key portfolios of ours which are affected by that. This is an estimate of the impact which we're expecting, and that will be at the end of Q1. It is possible that other portfolios could come within that framework. That's not what we're expecting at the moment.

Thomas Rayner

The actual portfolios were – the portfolios that we're talking about were primarily UK-based, or was there anything in Asia and other parts of – and is there a case of –

Jane Leach

Yes, principally UK. It's – I mean, there is an element of it in Asia, but it's small relative to the UK, and it's primarily across GBM and CMB.

Thomas Rayner

Is there a case of insufficient data just being the fact that it is a very well performing book, and there isn't a – so you're actually being forced to increase capital requirements across safe books because you haven't got enough default?

Jane Leach

Yes. That is exactly right, yes.

Thomas Rayner

Which, to Iain's point about expecting rational thoughts from the regulator, isn't very encouraging.

Russell Picot

We've gone there, Tom.

Iain Mackay

Yeah, we could imagine. I mean, you can talk about being hoisted on your own petard – it is a reflection of the risk appetite of the group.

Jane Leach

Yes.

Iain Mackay

But therein lies part of the challenge around the ring-fenced bank as well. So, let's say, a ring-fenced bank, which legislation would suggest is relatively narrow – it's basically mortgages, deposits, loans to SMEs, low risk-weightings, heavily deposit-funded institution – you apply a leverage ratio of that to 4%. There's not a bank in the UK that gets there.

Russell Picot

You see, Tom, in the – in our Pillar 3 document – I won't tell you the page number because you'll all go heads down trying to find it – there's an interesting disclosure where we show for the corporate book –

Iain Mackay

Go on, give them the number – page 60.

Russell Picot

– the estimated PDs against the actuals, and all the estimated PDs are higher than the actual PDs we experienced across our corporates, for the advanced models.

Jane Leach

Yeah, so, I mean, you also – you talked about other things in the future, and regulatory uncertainty going forward. Whilst we talk a lot about Pillar 2, the other two items, really, are ones which we've disclosed in the book, which are the RNIV offsetting of risks, which was there in the capital section in the ARA. Also, we're still waiting for CRD IV guidance around PVA inspections. So those are – and those really are the two biggest things that are out there. That said, of course, we are, as we say in these bullet points on the slide, there are a number of EBA technical standards that we're still waiting for from CRD IV.

Iain Mackay

So, we will keep you posted. We're literally – we are definitively trying to play some game of hide and seek with you, but nor are we trying to put out something that will artificially guide you to a number that you think we think we've got some certainty around.

Russell Picot

And for which we have no basis to support it.

Iain Mackay

No basis to support it. So we are not taking punts here; we are working off exactly what we know. Yes.

Ronit Ghose, Citi Investment Research (Europe)

Hi, just changing the subject away from capital to –

Iain Mackay

Quick mention of who you are, please.

Ronit Ghose

Sorry, I keep doing that. Ronit Ghose from Citigroup. Just changing the subject from capital to something that's been in the news recently, which is the volatility in the Yuan. Obviously we're all aware that the volatility is tiny compared to other currencies; it's moving in a small range. But could you add any colour or comment on what is happening on CNH, particularly the structured products between CNH and US dollar? How significant are these FX options for banks such as yourselves, in terms of generating revenues, and are there areas of client concern you have? I mean, we've seen this in previous EM crises – we have seen this in Korea, and Mexico, and Poland. When you have small volatility, suddenly you find there's a swathe of, I don't know, auto manufacturers or whoever, who should not have this kind of product, who ends up losing money. I am guessing you are going to tell me you are very well collateralised, and –

Iain Mackay

Or, I'm just not exposed.

Ronit Ghose

You are just not exposed to this CNH, US dollar structured product?

Iain Mackay

In terms of heavily structured product, I mean, the good thing about the renminbi is that it's a two-way deal now, right?

Ronit Ghose

Yes.

Iain Mackay

That's good. If you're going to float your currency, you don't want to float – it's never going to be a one-way bet. So, whether purposeful or otherwise by the Chinese authorities, the fact that we have got people actually having to think about what is going on from a fundamental perspective on the currency, against the US dollar, or any other – the Euro, or sterling, which would be our principle concerns – then that is a good thing. It is making people think about the risk at a fundamental level, and we think there's – you know, the fact that it's dropped off a point and a half – you know, that would happen on the US dollar; that would happen on cable and nobody would think twice about it, on a daily basis, right? So, in the round, we think this is good. In terms of having – if you think about our interbank exposures in China, it is to the top banks. We – our exposure to the metropolitan, the county banks, city banks – as they call them – is very, very limited. To the extent we've any, it tends to be those in which we've got significant share holdings, okay? Otherwise, the majority of our interbank exposures within China are to the BoComms, the Bank of Chinas, the CCBs, the Agricultural Banks, ICBC. That's the – because that's the extent of where the trade flows are, and that's what – and large corporate customers, and that is what we do in China.

If you think about – and what we don't do is, we don't go out there and trade a proposition in foreign exchange in any – really, in any currency – but we take a position based on customer requirements. So to the extent that we've got heavily structured product out there on a foreign exchange basis, on the renminbi versus any other currency, it is directly a function of client requirements – in which case they're structured with the appropriate levels of collateral against them. So, it's not – I mean, do we watch this very closely on a minute-by-minute, day-by-day basis? Yes, absolutely. Do we see it as a major risk for the organisation? No. Do we see the introduction of some volatility in the currency, in the round, being a good thing in terms of getting people really to think about this, as opposed to having treated it as they have, both at a corporate and at a retail level – a wholesale and retail level as a one-way bet? Probably a good thing.

Ronit Ghose

Can I just follow up, Iain? When you said you're not very exposed – I would imagine that you would be one of the biggest FX dealers in Hong Kong. I mean, along with the likes of us and some other banks, you would be one of the biggest FX dealers, and this is a huge part of the market – the FX options market, in this –

Iain Mackay

Absolutely.

Ronit Ghose

So when you say you're not exposed, it's because you're sufficiently hedged and collateralised, rather than –

Iain Mackay

Absolutely – but driven by customer activity, so collateralised. A great deal of what we're doing through that again is off the back of trade, and again, the duration of trade is pretty short, and again, is self-liquidating and well collateralised. So, the FX behind it is similarly structured.

Ronit Ghose

Right, and do you think there'll be problems for other banks, or other pockets of client bases, or is this just a big media noise?

Iain Mackay

Couldn't tell you. Don't know.

Ronit Ghose

Could you – sorry, one last question on that point – I'll give up now. Is there a – I mean, could – is there any number or quantification of how big a contributor to revenues it is for a bank such as yourself?

Iain Mackay

In terms of foreign exchange?

Ronit Ghose

No – within foreign exchange, how –?

Iain Mackay

I don't have that in front of me. I'm sure I could find it, but I don't have it in front of me.

Ronit Ghose

But would it be a material driver of foreign exchange revenue growth – those kind of products?

Iain Mackay

It would be not insignificant for our Chinese or Hong Kong business, but – I don't have the numbers, but in terms of the overall proportion of our foreign exchange revenues, it would not be significant.

Ronit Ghose

Thanks.

Iain Mackay

Fire away. We'll come back to you.

Raul Sinha, JP Morgan Securities plc

Right, it's Raul Sinha from JP Morgan Cazenove. If I can just, maybe, follow up on a couple of points, and then I just wanted to get your thoughts on note 43 – on the legal litigation stuff. But firstly, on BoComm, Iain, maybe to ask the question differently – we obviously understand the capital impact of that, and I think you've made it pretty clear how the dividend payout of the Group looks like the dividend payout. But it's fair to say that you're book value obviously does carry BoComm at a level which is much higher than the market price. That's been the case for a long time now. To ask the question differently: what would it take for you to write down the value in use, or the carrying value, down to market value?

Iain Mackay

I think, again, you would be looking at a value in use model that would have to – so, you get your fundamentals of what's going on within BoComm, and it's position within the Chinese economy – so you'd look at what we – you look at what's in note 21. It tells you about the growth rates, it tells you about the loss rates, it tells you about the discount rate. If you saw significant divergence from actual performance against those assumptions – and those assumptions are informed both by an outlook, but also to a significant degree by historical performance, and current data that we see coming through the BoComm financials that we see – which is what you see; we do not get a line of sight to financials any sooner than the market does – so it would be informed by the performance of the firm. So, while the firm continues to grow, and to be profitable, and to pay dividends, then, you know, there'll be some delta between the value in use and our carrying value. That will be reflected in the accounting that Russell described earlier – then, yes.

But to see, then, really a value in use migrating towards the market value, then I think you'd need to see some fairly significant drop-off in the growth within the Chinese economy, within BoComm within the Chinese economy, or a very significant ratchet up in terms of losses that you see coming through. So again, the value in use model is – it's like a model that you guys work off, okay? It – there's nothing particularly mysterious about this; it's a discounted cash flow model. The assumptions change, which will be informed by the actual performance changing, then that would be reflected in the accounting. Going beyond that, if there was a change of our intent with respect to BoComm, right – so, if we were to change our intent from, this is a long-term strategic partnership – and there's no intention of change in that regard – then that could change the accounting. But that would be quite a separate issue.

Raul Sinha

But it did happen with Ping An, for example.

Iain Mackay

Aye, for very different reasons, right? But then you saw the effect of that on our accounting.

Raul Sinha

Yeah, positive. Then the second one, just to follow up on Ronit's question – I couldn't find the number anywhere in the annual report – maybe I missed it. Do you disclose your cross-border exposure to the Chinese currency. One of your peers does do that.

Iain Mackay

So there's – I think within Pillar 3 there's structural FX position, as it relates to the renminbi.

Raul Sinha

If you had to estimate how much lending – how much FX lending has been booked out of Hong Kong onto Chinese mainland corporates, should we try to do it the same way as we have done before – look at the growth rate over the last few years and try and estimate some proportion of that is directly related to the mainland? Or is there a number that you'd give us now in terms of how much of the Hong Kong borrowing relates directed to mainland?

Russell Picot

So when we – when we file the 20-F – I don't know whether it is a day or two, we do disclose cross-border outstandings within the 20-F for the major countries. You know, I don't remember off the top of my head which those countries will be at December 2013, to know whether or not those exposures would be pulled through into that disclosure.

Raul Sinha

It would be useful to have historicals as well, going back four years –

Russell Picot

Yes. So it goes 13, 12, and you can look at the 20-Fs to get the history of the cross-border exposures.

Raul Sinha

And then the last question, just on litigation and legal proceedings: can I check what is the size of the provision against Jaffe?

Iain Mackay

Sorry, say that again.

Raul Sinha

Against Jaffe. You do say you've made a provision.

Iain Mackay

No, we don't disclose that one separately. We have made a provision, but we don't disclose it separately, so if you look at note 31, it tells you what we've provided overall for legal exposures. Within that, there is a provision for Jaffe, which is a reflection of where we think our expected likely outflows will be. Again, as described in that note – in note 43, rather, which goes through the legal exposures in some detail, what has developed in Jaffe is that we've now been given leave to appeal. So the judgment came down; we posted a bond for the judgment, which is about 2.5 billion. That stays, if you like, the execution of that sentence, and we now go through the appeal process. We've filed our brief for that. I read the brief. If I was the judge, I'd just dismiss the case today. It was a really, really good brief, but, I mean, that will go through an appeal process in the 7th circuit. That could take a long time. It could actually come to fruition this year. That's our – that's certainly our hope, that it will come to some fruition, either in the form of a new trial, or in the case being overturned.

I think – I wouldn't like to guess as to the outcome, because there's a panel of judges sits on this in the 7th circuit. The 7th circuit's got a reputation for being very technically orientated when it comes to Securities cases. So they will go into both the judgments that were formed by the judge in the district court, as well as the actual facts that were presented, and will go through the appeal process. But that – if we get a good outcome, we will get a result this year, good or bad, and – but it could – you know, this could go on for a couple more years. But our provisioning is based on our expected cash outflows.

Raul Sinha

And then, Libor and FX – obviously there's quite a lot happening in the background on the Euribor stuff. A lot of banks obviously have been mentioned on FX, and yourselves obviously, there's still outstanding issues around the Libor investigations directly; is it your understanding that at some point, there might be a capital add-on, or some kind of capital treatment, required for the UK banks for this issue?

Iain Mackay

Is it – so, you know, this falls into the category of operational risk. So today, we carry 10 billion of capital associated with risk-weighted assets for operational risk. Could that be augmented because of – I mean, that was actually one of the factors that influenced FPC adjustments in the middle of last year. To the extent that there was anything significant that came out of FX investigations, which are at an extremely early stage – very, very early stage, to the point that the actual framework for doing an investigation has still not been finalised by the FCA – far too early to say. I mean, what we have provided in note – I think 43, it is – is based on everything that we know at this point, and any facts related to that – just far too early, as to determine whether there's been any wrongdoing, and to the extent of any such wrongdoing that might arise. As far as Libor goes, again, same story. You know, we have disclosed everything we know in that respect. We think we've got a reasonably clean reputation in that respect, but again, the FCA continues to – not just the FCA, but authorities in plenty of jurisdictions, some of which have, sort of, dismissed it and said, right, 'There is no findings to – that would support any legal action against the firm', that's happened in a number of jurisdictions – but I think Libor has got a long way to roll, as well.

Christopher Wheeler, Mediobanca Spa

Yes, Chris Wheeler, Mediobanca. Just, first of all, a very boring accounting question on BoComm. I do assume that if we have these two items – both the recording of the income and the charge – they will go through the same line. Or is there something really weird in IFRS that's going to make this far more complicated?

Russell Picot

I think they'll be displayed next to each other, but down in that –

Christopher Wheeler

I've qualified too many years ago. Now I realise that.

Iain Mackay

It'll all show up in our associates line; it'll show up in the associates line.

Christopher Wheeler

Okay, it will – thank God for that. Okay, can we – can you talk about the subject of trade finance margins, because obviously it has been a big topic. One for your competitors also – Stuart talked about it in a very amusing fashion on Monday. But it strikes me that a number of people who actually stepped back from that market have, sort of, de-leveraged, and are now, perhaps, coming back into the market again – which adds another headwind for you. Just give us any view, what you think the trends might be over the next, sort of, 18 months, on that area.

Iain Mackay

As to the next 18 months, I couldn't tell you. I can tell you what we've seen happening over the last 12 months. The first half was incredible compression coming through trade finance, principally in Asia. The second half of the year, particularly the latter part of the year, we saw stabilisation. We didn't see significant recovery, but we saw a reduction in the – you know, the rate at which the compression was coming through slowed significantly. But we are still not back to the point at which we started 2012 in terms of net interest margin on trade. But the decline has slowed very significantly.

Christopher Wheeler

So it's a matter of – I mean, competition will continue to come in, but it's a matter of waiting for rates to move, and that's when you can start to see some upside.

Iain Mackay

I mean, the volumes in trade in the first month of the year were fairly attractive. Pricing held steady to what we saw in the fourth quarter. But, you know, again, it's something we're watching on a daily basis, and getting a good view of it across the group on a monthly basis. But no, the information coming through from our Commercial Banking business, particularly in Asia, this week, end of last week, was that there were – the trends we have seen over the last few months were holding reasonably sound.

Christopher Wheeler

Okay. Perhaps I could ask a few questions about global Private Banking, and just try to get some kind of feel for what's going on outside, perhaps, of Asia, around the Monaco, Switzerland. I mean, you – this time last year, you remember, we had a chat about the goodwill, but you hadn't had your value in that's why I asked you earlier, but you didn't tell me it was Monaco. But, I mean, you didn't sell that business in the end. Are you happy that it's, sort of – do you now feel that's cleaned up? Obviously, with the Geneva business, you made it very clear, I think, that you've been shedding assets there as you try and get that into the shape that you want it to be. I mean, I am wondering how far down the line are you with that particular area, which I know you are very keen to get, sort of, on a – you know, on a basis which is, which you feel comfortable with – and perhaps get a feel for, you know, are you worried about the French, you know, coming after you – as they are, perhaps, one or two of the other big wealth managers? Then in relation to that, the charge you took – I keep forgetting what the number was; I mix it up with – there was a 352 million which you took from the regulator. Some of that was clearly in the UK. I think the market view is now – some are saying it's the US. Just checking that that's mostly what it is.

Iain Mackay

No, it's a provision for the fact that we are one of the banks that's under investigation by the Department of Justice in the US – topical this week, when you think about it. The provision is, again, based on our evaluation of possible or expected cash outflows as we work towards the resolution of that matter with the Department of Justice. Again, we're in the same boat as everybody else in terms of trying very hard to collaborate with the Department of Justice, while not – while at the same time, respecting Swiss law. That's not always particularly easy, but there are protocols developing. There is actually a protocol that's been agreed, but the implementation of that, the details of how that's implemented, is proving quite difficult, because again, the protocol that is agreed – one interpretation of it by the US is different to the interpretation of it by the Swiss.

So we'll continue to work through that, which is a wider issue, but in terms of repositioning the Swiss bank – which is where the focus of our energy is – and to a lesser extent, the business in Monaco – is, we very clearly identified the kind of business we want to do in our Private Bank, full stop. What we've then done over the course of 2013 is match the kind of business that we want with the kind of business that we've got. We've identified – and it's principally in Switzerland, Monaco, and to a slightly lesser extent, one or two other locations round the world, but to a much lesser extent outside continental Europe – is, there are portfolios of assets which we would rather not own, either because of the return criteria, because of the relative size of each individual customer against criteria that we have established for the Private Bank. So we've got quite a lot of very small deposits there which, as we have defined it, don't really – from a returns perspective, the amount of focus you've got to give to it from a Private Banking perspective, given the size of the customer relationship, it probably better fits in the Premier offering from an HSBC standpoint.

So there is a reshaping within the European – the continental European Private Bank, where there are some portfolios which are up for disposition. That effort will progress throughout 2014. There are some portfolios which we are focusing on a transition of those customers into Premier. Whether those customers choose to go into Premier, or choose to take their business elsewhere, will remain to be seen. Then there is a very clear set of criteria against which the business is focused on growing assets under management. Therefore, that is really the effort that – having spent a year deciding what the shape of the portfolios, the kinds of business that we want to do – really, Peter Boyles and his team's focus in the

latter part of 13 and 14 was growing that part of the business that we want to develop and retain, and is attractive to us, and continuing to run down or dispose of those parts of the business that we don't particularly want in the Private Bank.

The – what we clearly see is, the relationship between our Commercial Banking business and the Private Banking business being absolutely vital. We know our customers in the Commercial Bank very well. We track them, generally speaking, for a long period of time, and when there are wealth events within that Commercial Banking base, the notion that we would know that customer well enough, and their needs well enough, to take them into the Private Bank and continue to build that relationship is something that we have not done as good a job in the past of optimising. That is a very clear focus for Peter Boyles and the team. But I think that the – certainly, the efforts around 14 will be to complete the reshaping of the portfolio within the European Private Banking business. But there's a very clear focus around what we can grow – what we want to grow, and how we grow it. I think that we've got a business proposition that absolutely enables us to do that. I think that's borne out by the fact that we're able to continue to attract new money in other parts of the business around the world, particularly Asia.

Chintan Joshi, Nomura International Plc

Good morning. Just, one on GBM and then a very few quick ones on North America. GBM Europe, If I back out the one-offs, NQH, or the asset sale gains in BSM last year, GBM looks like up 10%, which is – I was finding it difficult to believe that Europe actually grew in GBM, so is that right? Have you managed to do it? And then a few quick ones on North America.

Iain Mackay

Were we able to grow revenues in GBM by nearly 10% last year? On an underlying basis, yes, in fact we did.

Chintan Joshi

What is driving that?

Iain Mackay

So I think if you look at – so there is a one-off within that, which you're probably not picking up. No, that's the PBT lever. Are you looking at revenue or are you looking at PBT?

Chintan Joshi

Revenue.

Iain Mackay

You're looking at revenue. So, on a revenue basis, there was an item sitting in GBM in Europe, which – you will recall in 2008 or 2009 we took a significant write down on Madoff-related exposures. As the entire Madoff process has moved forward, we actually took a write-up against some of those positions, of some 200 million in the 4th quarter of this year, okay? That was negative 358 last year.

Chintan Joshi

No, I've adjusted for that.

Iain Mackay

You've adjusted for CVA, DVA. So beyond that, strong year in debt capital markets, equity capital markets. Robust performance within rates – rates were somewhat influenced by an OIS adjustment in the 4th quarter. So that is just the bases of valuation, as we continue to refine the bases of valuation within the collateralised derivatives business within rates. That was an adverse effect in the 4th quarter. But overall, it was principally strong performance coming through equity capital financing, debt capital markets, foreign exchange continued to behold a robust performance, the Securities business continued to perform well, and Payments and Cash Management continued to perform well.

Chintan Joshi

Thank you. Then if I move on to North America, I mean, I am trying to back out the things we should be ignoring – so household revenues, GBM revenues – so that I can think about North America excluding those two. Again, that seems to be quite strong performance out there. I find volumes have gone up tremendously in H2 in North America as well. So what – is the volume growth driving the revenue?

Iain Mackay

I am trying to think – was there anything particularly unusual in the second half for North America and GBM? Not that I can think of. I mean, you know, I don't think Madoff was impacting that. I don't think – OIS did not impact that at all.

Chintan Joshi

I have 18% growth in North America revenues, excluding household, GBM and one-offs.

Iain Mackay

Okay, are you looking specifically – oh, you're looking at the whole of the US, not just Global Banking and Markets.

Chintan Joshi

I am looking at North America, excluding household and GBM.

Iain Mackay

Oh, the whole of North America, okay.

Chintan Joshi

So, traditional banking in North America.

Iain Mackay

So, development within the CMB business.

Chintan Joshi

But then US CMB profits are down, year on year, so –

Iain Mackay

Yes. Principally because of a couple of impairment charges, but overall the revenues have grown. Same factors, actually. Again –

Chintan Joshi

18% – I just want to – because it's a big number, which is what I'm trying to justify.

Iain Mackay

It is. There's nothing particularly extraordinary in there, is there?

Iain Mackay

So, North America, overall…

Chintan Joshi

Volumes are up 20% from the end of H1 to [inaudible] –

Iain Mackay

So I guess the question, Chintan, is what have you carved out? Because you might have carved out a bit too much.

Chintan Joshi

That would take a long time. Well, anything that would seem like non-recurring.

Iain Mackay

Well, you tell me, I am not going to tell you!

Chintan Joshi

We've got – I've got, I think, a list of 40 one-off items across the group, so –

Iain Mackay

No, but they're not all in North America.

Chintan Joshi

Yeah, I'm just –

Iain Mackay

So what clearly impacted North American revenues were losses that we occurred in the disposal of non-Real Estate and Real Estate credits in HBIO. I think when you added all that up, that came to about 400-odd million – just slightly short of 500 million. The early conclusion of cash flow hedges, which was about 199 million – all this stuff was disclosed in the financials. Within North America –

Chintan Joshi

Or, let me put it another way. What growth rate do you see in North America in traditional banking?

Iain Mackay

No, but the Canadian business, from a Commercial Banking, global banking and markets business, is an absolutely steady business. There were very few odd items came through that. We had a significant impairment of a Real Estate position within one of our Commercial Banking clients that hit us to the tune of about 40 million this year, but setting that aside, it was a very normal growth for the Canadian business in 2013. In the US business, the factors that need to be reflected in the US business was the 199 on cash flow hedges early termination, as the conversation on the portfolio changed, as we run down the non-Real Estate and Real Estate – principally the Real Estate business. The disposition of 7 billion of non-Real Estate and Real Estate loans, which knocked about 450 million of profits off the – you know, out of the revenue line – losses that we incurred in that space. Going beyond that, we have another 200 million, 300 million of revenue declines just because of the reduction in size of the HBIO portfolios.

Those, really, are the factors which need to be brought into consideration for the US business. When you take that, foreign exchange, and last year's – 2012's – dispositions of the US branch and the Cards and Retail Services businesses out of the equation, then year over year we saw business that was certainly not 18%, but was, sort of, in the 4-5% range up. That is in line with what we think is reasonably possible in that business.

Iain Mackay

Okay, there's a call from Hong Kong. So is somebody on the line from Hong Kong? Is there a question?

Steven Chan, Kim Eng Securities (Asia Pacific) Ltd.

Good morning, good morning guys. This is Steven Chan of Maybank, Kim Eng. I have a few questions more related to Hong Kong and China. But first of all, for Hong Kong and Shanghai bank, if you compare the second half net interest margin and first half net interest margin, indeed there was no improvement.

This is quite contrary to what we have seen for other large banks, which – even Hang Seng bank we have seen quite a sharp improvement in that interest margin in second half compared with first half. So I would like to see the reason behind for that, and then I have two other questions on China.

Iain Mackay

I think it's probably the underlying nature of the business we are doing that has come through from a trade perspective. We didn't see a significant improvement, but we did see a significant slowdown in the rate of deterioration within the trade and receivables financing business. I think some of the perhaps slightly more domestically orientated banks did see some of a pick up in the market place, but overall, what we saw in the second half of the year was more of a stabilisation in that regard. I think the other thing that's worth mentioning on is that in the second half of the year, we moved – we've done a corporate restructuring where we've brought our global Private Bank into the Hong Kong bank. So, broadly speaking, our Private Bank was structured out of Switzerland, with branches of the Swiss bank in various locations around the world. What we have actually done is integrate the Private Bank – we've done this in the UK, we've done this in Hong Kong; it was already the case in the US – where we have brought the bank into being a division – we've brought the Private Bank into being a division of the Hong Kong and Shanghai Banking Corporation in Hong Kong. In that respect, there was some impact on net interest margins in the second half of the year from that, which to some degree, certainly, would probably differentiate the stabilisation that we saw in net interest margin in the second half of the year, versus, perhaps, some of the improvement you have seen in others.

Steven Chan

Lending spread – just single out [inaudible] Hong Kong business in the second half.

Iain Mackay

I'm sorry – what's –

Steven Chan

Did you see any rise in the lending spread, say, for your corporate loans in Hong Kong in the second half, compared with first half?

Iain Mackay

No, in the round, we saw stability. We didn't see, necessarily, significant expansion in the spread.

Steven Chan

Okay. Second question is on China. How do you see – how do you compare the net interest margin and the asset quality of your direct China banking business in second half compared with first half – the net interest margin and the asset quality trend.

Iain Mackay

Alright, hang on a sec. I think I've got that. Pretty much flat – half over half.

Steven Chan

Even for asset quality?

Iain Mackay

Yes.

Steven Chan

Okay, and finally, a follow-up question on the exchange rate of RMB and US dollar. You just mentioned about that, you know, some of the structured products, maybe, you know, or even the forex dealing would be related to, you know, customer-driven activities. Indeed, what we've heard in Hong Kong – what we've seen that is some of, you know, the recent depreciation of RMB against US dollars could be related to some of these so-called, you know, accumulator activities for some of the private clients,

because they bet on appreciation of RMB against US dollar. Because of these accumulators, then they will have to accumulate these RMB, and then because of the depreciation of RMB, then they will have to cut loss. I just wondered whether you have seen such things for your Private Banking clients, say, in Hong Kong? Are you doing a lot on these accumulator activities for the past 12 months?

Iain Mackay

I don't believe so, but I think that's a question you're going to have to put to Sarah in Hong Kong. I don't know.

Steven Chan

Okay, thanks.

Iain Mackay

Okay. Please go ahead.

Fahed Kunwar, Redburn Partners, LLP

It's Fahed speaking from Redburn. Just – I had a couple of strategic questions. The first one was just, to the point that you made – it's, kind of, capital related. But – the uncertainty on capital, and the effect on your growth prospects going forward – I mean, when the US banks are coming out and saying they have got their capital ratios finalised, how does that not impact how you think about growing your franchise in Asia, when you are still, you know – it is very competitive out there. Does that not start to have quite an deteriorating influence on the way you conduct your business in Asia?

Iain Mackay

Well, no. Again, we need to go back to how we manage capital within the group. We manage capital on a subsidiary by subsidiary basis. If you look at the capital ratios of the Hong Kong and Shanghai Banking Corporation and they are strong capital ratios with an incredibly strong liquidity position. Therefore, the propensity – and this is generally reflected across the majority of our subsidiaries around the world – the vast majority of our subsidiaries around the world – is that they're well capitalised at a local level, they're liquid at a local level. Therefore their ability to compete at a local level is not necessarily adversely impacted, in the round, by uncertainty of the capital requirements of the group within the margins that we are talking about, okay?

So, the fact that, you know, the competitive landscape, as it relates to ourselves versus, for example, American banks in Asia, hasn't really changed significantly, even over the last three to five years, where we've seen – whether it's been influenced by uncertainty from a regulatory capital management framework, or whether it has been implemented – impacted by other factors, for example liquidity – that hasn't really changed our ability as a franchise, particularly in Asia, to be very competitive in the market place. Which is informed by the depth of – frankly, the depth of experience that exists in the 23 markets in which we operate across Asia, the capital strength and the liquidity strength that we've got in that marketplace.

When we've got – when we look at the entities being able to self-capitalise, against local reg requirements as well as the consolidated reg requirements of the group – and generate $10 billion worth of capital for the group, net of dividends on a declared and paid basis of over 7 billion – then no, it doesn't, in the round, significantly affect our attitude on a day-to-day basis in terms of being able to compete in the market place. It's at the margin that this talks about. If you start ending up with very wide divergence in terms of the capital requirements against one particular jurisdiction's banks, versus those that are headquartered in the United Kingdom, that may become a feature. But we don't see that. Not at the moment.

Fahed Kunwar

I guess your group ROT gets affected. So your – the group ROT, or you can make – the capital sitting in the Head Office, for example – on the subsidiarised level it doesn't affect it and that's fine, but the ROT you make in the group would be potentially less than some of your competitors' banks. I guess that

might be something you'd have to accept if you want to keep up the same levels of growth. Because as an investor, you're buying into the group ROT ultimately, so where the capital sits –

Iain Mackay

So the capital sits in the subsidiaries. Our consolidated capital ratios, with the exception of a relatively small capital – liquid capital buffer that we hold at the parent company – which makes up considerably less that 10% of our overall – yes, considerably less than 10% of our overall capital resources for the group – the capital sits in the subsidiaries. That's essentially where it sits.

Fahed Kunwar

The other question I had was around the HKMA we were talking about. It was quite interesting – the external trade that China is transacting in renminbi has increase to, kind of, I think, 10-12%. He's talking about that increasing to 13-16%. Now, one of the big strategic advantages that yourselves along with a couple of peers have is your significant dollar liquidity. As that kind of shift happens, and you get further internationalisation of the Yuan – obviously capital markets deepen, but then the domestic banks become a lot more competitive because they have access to Yuan liquidity that perhaps you don't have. I mean, how do you see that as a strategic threat, kind of, in the medium term?

Iain Mackay

Well, we have ample access to the renminbi. I mean, in terms of – we are in the top three from a deposit-taking perspective in Hong Kong. In terms of our ability to provide renminbi settlement capability, we've got that in more than 50 countries around the world. There is no other bank in the world that can do that today. In terms of being at the forefront of developing an investment market for renminbi-related products, again it's really ourselves and possibly Standard Chartered that are at the forefront of that within the Hong Kong and within the Asian marketplace. So I don't – again, when you look at it against a Hong Kong marketplace, I think HSBC, Hang Seng are absolutely at the forefront in terms of being able to compete in that respect.

Now, when you look at us against Bank of China, well that's a slightly different dynamic, okay? I mean, Bank of China has got a surplus in that respect which dwarfs everybody else in the marketplace. Hencetofore, Bank of China has tended to compete very much on price and, you know, again, I think as time progresses they will continue to become more sophisticated. But also, as time progresses, there's an expectation that the liberalisation of the currency will become even deeper, and therefore, wider access to a wider number of players. But when you look at our direct competitive stance in Hong Kong, the wider Asia, and the wider world, in terms of being at the forefront of renminbi and supporting renminbi liberalisation, settlement – we are number one.

Nick Collier

Yep, okay, sorry Manus.

Manus Costello, Autonomous Research LLP

Thanks Nick. It's Manus Costello from Autonomous. Iain, this time last year, we were beating you up for a Q4 pick up in underlying costs, which didn't happen this year, so thank you for that. Shame about the revenues, but maybe next year. I was looking at the walkthrough of costs for 2012-2013 –

Iain Mackay

I don't think we were necessarily alone for 4th quarter challenges on the revenue line, but –

Manus Costello

True. But I was thinking about next year's cost base. Looking at the way you presented it in your waterfall chart, slide 10, the pick up in inflation and investment was pretty much offset by the sustainable cost savings in the course of the year. Is that the kind of dynamic we could expect to see in 14 and 15 as well, or do those cost savings now fade, and so there should be a bit of underlying inflation coming through.

Iain Mackay

Again, as Stuart and I said on Monday, we've got another sustainable cost saves outlook there over the next three years of 2-3 billion. We set out 2.5-3.5 billion for 11-13, and we generated 14.9 annualised sustainable saves. The firm's view – although we have certainly made the firm leaner from a management perspective, in terms of four global businesses, 11 functions, managed through the operating regions in which we operate – the degree of simplification, and the opportunity for that simplification across practices and procedures within the group, remains very, very significant. It is – you know, as we work through that, there are degrees of complexity being added from a regulatory, compliance standpoint – whether from a conduct or from a prudential regulation standpoint – and some of the investment in that is reflected in the step up in the run rate that we've identified in those charts.

But the ability to continue to streamline at a technology and at a process level within the firm, we view as very, very significant, which informs the 2-3 billion of sustainable saves that we have targeted over the next three years – against which we have built a very robust pipeline for 2014, which the teams are delivering. So that the – if you like, the modus operandi has not changed in the slightest, and the focused, and the continued streamlining and simplification – perhaps not structurally of the group, but in the day-to-day operation of the group in terms of interactions with customers, regulators, employees – will continue to be a very significant focus for the next three years.

There's just a simple reality that we'll continue to have inflation in the markets in which we operate; whether it's the United Kingdom at one end of that scale, or blithely, at the other end of the scale, the Argentinean market. So it is one of the things – so if you go back to the Investor Day we did in 2011, one of the features that informed the sustainable saves programme was the recognition that we needed to continue to invest in the growth and the capabilities of the firm, the recognition that we needed to build a hedge capability against the natural inflation that comes through the dispersion of markets in which we operate, and the need to continue to improve the overall cost efficiency position of the group.

So, from 2012-13 there was significant progress made – not just on sustainable saves, but the cost efficiency position of the group. We reduced it on a reported basis by six points, and we reduced it by, I think it was about three points on an underlying basis. We've got a middle-fifties target for cost-efficiency ratio – on an underlying basis, sitting at 59.3 or 59.6. We've still got a bit of work to do to get into what we would define as the middle-fifties. That's what informs what we are doing within the group. So the game on the cost front is not up at all, but in the round what we are focused on is progressively moving towards that middle-fifties cost-efficiency ratio, and there's more work to be done.

Nick Collier

Thanks very much, and thank you everybody for your questions, and thank you Iain, Russell, and Jane, for the answers.

Iain Mackay

Thanks very much indeed.