Edited Transcript

Interim Management Statement 1Q 2014

Presentation to Investors and Analysts

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Corporate participants
Stuart Gulliver, Group Chief Executive
Iain Mackay, Group Finance Director

HSBC

Stuart Gulliver, Group Chief Executive

Thanks very much. Good morning, everyone, and welcome to our first quarter results call for analysts, investors and the media. With me today is Iain Mackay who's going to talk through the detailed financial performance. Then we'll both take questions, starting with those from analysts and investors. But let me first start by putting our results into context.

Whilst revenue was lower than the previous year's first quarter, which benefited from a number of very specific items, we have actually seen progress in revenue over the trailing three quarters. Alongside this, our return on equity was 11.7%, we maintained a tight grip on costs, loan impairment charges were under control, and our capital position remains strong.

Finally, looking at our global businesses, Global Banking and Markets had a relatively good performance and we grew our market share in several product categories. Commercial Banking saw revenue growth; but in our principal Retail Banking and Wealth management business, revenues were impacted by changes in incentive plans and product pricing. In the long run, we believe these changes to retail banking wealth management will benefit customers and shareholders.

I'm now going to hand over to Iain to go through the details.

Iain Mackay, Group Finance Director

Thanks, Stuart. I'm going to take you through some of the financial highlights and then go into more detail on revenue, costs, loan impairment charges and capital.

For the first quarter, reported profit before tax was $6.8 billion compared to $8.4 billion in the prior-year period. Underlying profit before tax was $6.6 billion compared to $7.6 billion in the first quarter of 2013. Of the $1 billion decline, $741 million was due to significant items, most notably the Ping An disposal completed in the first quarter of 2013.

Looking at some key metrics, the reported return on average ordinary shareholder's equity was 11.7% compared with the target range of 12% to 15%.

Our cost efficiency ratio was 55.7%, which was within our target range of the mid-50s. On an underlying basis, we had a negative jaws of 6.4% which in part reflects a number of significant items that benefited our performance in the first quarter of 2013. I'll come back to these in a moment.

The advances-to-deposits ratio is marginally higher at 73.9%, well below our 90% cap; whilst our common equity Tier 1 capital ratio on an end point basis was 10.8%, comfortably above our target and reflecting a strong capital position.

The next slide shows the reconciliation between reported and underlying profit before tax, and adjusts for movements in the fair value of our own debt, key transactions which we've broken out for you under operating results, together with foreign currency translation differences.

Additionally, we've identified a number of significant items, including the underlying profit before tax, which impact the financial performance of the business. I'll talk about these in more detail in the next slide.

A key point here is that of the total reduction of $1.6 billion in reported profit before tax between the first quarter of 2013 and the current quarter, $1.4 billion was due to disposal gains, reclassifications, and other significant items.

Included in underlying profit before tax are a number of items which are linked to restructuring and repositioning of the Group, have an element of recurring volatility, relate to customer redress and litigation, and include the bank levy. All of these have been previously disclosed, but this is a useful summary to assist analysis.

The overall lower level of significant items in the first quarter of 2014 is a key factor driving lower underlying revenue compared to the prior-year period, accounting for a total of $1.1 billion of the $1.4 billion reduction in underlying revenue.

This lower level of significant items in the first quarter of 2014 also reflects the fact that the program of major restructuring the Group has undertaken over the last three years is almost complete. You'll find more details by region and by global business for this and the previous four quarters loaded in our investor relations website.

Now the main themes in revenue and costs. This slide shows the global business revenue after adjusting for underlying and significant items.

Overall, revenue was down by $350 million, or 2%, with growth in Commercial Banking offset by a decline in retail bank wealth management and Global Banking and Markets.

Running through each of the global business drivers within this, in Principal Retail Banking and Wealth management revenue was down by $117, million or 2%, which reflected the run-off of our Canadian consumer finance business, lower mortgage fees in the US, lower overdraft and investment fees in Europe, partly offset by increased revenue from savings and deposits mainly in Europe and Asia.

Revenue from our Retail Banking and Wealth management US run-off portfolio was down $205 million following loan sales in 2013 and lower average balances.

We grew revenue in Commercial Banking by $199 million, or 5%, driven by growth in average balance sheets in Asia and increased collaboration with Global Banking and Markets.

In Global Banking and Markets, excluding legacy credit, revenue declined by $290 million, of which $226 million was from Balance Sheet Management, as the first quarter of 2013 included higher gains from the repositioning of the portfolio for risk management purposes.

Excluding balance sheet management, revenues fell by 1%, which was, given the prevailing trading conditions, a good performance.

We also increased our market share across several product areas, including equity capital markets, debt capital markets, advisory and lending.

Capital financing decreased as volume growth across the business was more than offset by spread and fee compression.

Revenues in our rates, foreign exchange and credit businesses fell by 13%, 8% and 24% respectively compared to the first quarter of 2013, as they were affected by subdued activity levels across the industry.

However, our equities business grew by 36% as client flows increased; and revenue from our global Private Banking business fell by 13% as we continued to reposition the business.

However, we saw increase in net new money in areas we target for growth, including our home and priority markets and high net worth client segment.

On operating expenses, again separating the underlying adjustments and significant items, we've seen an increase of $164 million, or 2%. Looking at the key drivers here, principal Retail Banking and Wealth management was up by $163 million, mainly in Latin America and Asia, driven by higher staff costs reflecting inflationary pressures and an increase in risk and compliance costs.

Commercial Banking was up by $88 million, again driven by Latin America and Asia, due both to inflation and investment and staff support revenue growth.

Against this the continued run-off of the US portfolio led to savings of $55 million.

Overall this quarter, we've shown our ability to manage cost effectively, and will continue to look for further cost savings guided by the revenue outlook and our focus on simplifying and streamlining our business models.

Turning now to credit quality. Underlying loan impairment charges were down from $1.1 billion to $796 million. This was mainly due to a decline in North America which was down $269 million, reflecting reduced balances and lower levels of new impaired loans in the US run-off portfolio, together with improvements in US housing conditions, although the rate of improvement was lower than in 2013. Europe was $74 million lower, reflecting lower specific impairments mainly in Commercial Banking in the UK.

Finally, capital. The Group's common equity Tier 1 ratio on a transitional basis was 10.7% compared to 10.8% at the year end, and on an endpoint basis was 10.8% compared to 10.9%. Internal capital generation contributed $4.5 billion to common equity Tier 1 capital, being profits attributable to shareholders of the parent company after regulatory adjustment for own credit spread and deduction of our first interim dividend net of planned scrip. We've also benefited from a higher fourth interim dividend scrip take-up.

The marginal reduction in the ratio largely reflected increased RWAs resulting from the application of LGD floors by the PRA for several of the Group's portfolios, driving an increase of $34 billion in line with expectations. In addition, there was lending growth of $8 billion, mainly in Asia and in Europe.

The next slide shows how we're positioned against evolving common equity Tier 1 regulatory requirements. We show the PRA's current Pillar 2A guidance, of which 56% is required to be met by common equity Tier 1 capital from January 1, 2015. This currently accounts for 87 basis points in common equity Tier 1 ratio terms.

Whilst the regulator has yet to determine when and at what level certain buffers will be applied, HSBC is well ahead of current CRD IV capital minima and PRA guidance, and well positioned to meet increasing capital requirements.

That concludes the presentation. Now let me hand back to Stuart.

Stuart Gulliver

Thanks, Iain. So, operator, we'll now take questions.

Questions and Answers

Chintan Joshi, Nomura.

I have two questions. The first one is if I think about your revenue trends excluding GBM by geography, could you elaborate on how do you see revenue trends across the different geographies? Which geographies performed better or worse than you were expecting?

Iain Mackay

Thanks, Chintan. I think from a geographic perspective, I would say the performance is largely in line with expectations. We continue to see some revenue development within the Asian business. We see the UK as largely stable; the Middle East is largely stable. Some progression in North America, specifically within Commercial Banking within that North American space, driven both by the US and Canada. Latin America certainly under a little bit of pressure, particularly in Brazil.

I think that's probably the best way to describe it as we see from a trends perspective.

So I think overall, Asia remains broadly constructive, and I think we probably reflect everywhere else as being generally stable, with certainly some pressures in a couple of our Latin American businesses.

Chintan Joshi

Thanks. That was helpful. And the second one was on stress test. Could you elaborate on how you think the stress test will be run for you, what kind of economic scenarios is the PRA expecting to test; and how, if you've had any initial assessments on your capital position?

Iain Mackay

Chintan, we've had no -- I think we're in the same boat as everybody else in the UK. We are certainly subject to the same scenarios from a stress testing perspective as those which were published a couple of weeks ago.

Stuart Gulliver

April 30.

Iain Mackay

So there is no particular scenario being set out specifically for HSBC. One of the things that we've done from an internal stress testing standpoint is a particular focus on stress testing our Asian businesses. I've got no doubt that the PRA will take that work into consideration as well as form their own view in terms of our exposure to Asian businesses.

But as it relates specifically to those scenarios being applied by both the PRA and the EBA, we are in the same boat as everybody else. There is no particular guidance being provided to us at this point as to how the PRA, or for that matter the EBA, view our capital position other than that which was provided to us last Summer on the back of the FPC exercise.

Stuart Gulliver

Actually, there's just one other thing that might be worth just thinking about is in the context of the UK stress test and the decline in residential house prices of 35%, the average loan to value of our UK mortgage book is 47.3%, and the average loan to value of new business that we've written in the UK mortgage book is 60%.

Chintan Joshi

You're clearly defensive. And can I just add one more question for clarification, probably for Iain? Iain, own credit adjustment is not a part of significant items, so I need to back it out. Is that correct?

Iain Mackay

Fair value on debt is part of the reconciliation between reported and underlying which we've got on a slide for you, Chintan.

Chintan Joshi

Yes, but it's not a part of significant items.

Iain Mackay

No, it's not.

Chintan Joshi

Yes, perfect. Thank you.

Stuart Gulliver

Thanks very much. Okay. Can we take the next one, please?

Chirantan Barua, Sanford Bernstein

The first one, I was looking at the loan-to-deposit ratio. You said you wanted to run the Bank at 90%. Fortunately or unfortunately, right now you're at 74%, and in a base rate environment which is not very conducive. So I just wanted to understand, if we get into a scenario where we don't have rates rising for, say, the next three years, what's plan B, and how are you guys thinking about it?

And the second one, what's the next leg on cost, and especially with two views, one on the investment bank? Because there have been lots of structural headwinds that banks have realized over the last six months. The other one is on what you call your Principal RBWM. Is there a further opportunity in terms of network cost that can be taken out?

Stuart Gulliver

Okay. So, look, on the AD ratio, the AD ratio is actually not a target, it's a cap. So, we would never want to have an AD ratio higher than 90%, but obviously, we've got quite a lot of flexibility from where we stand at 73.9% to 90%.

We continue to find deposit inflows; we continue to actually be a beneficiary of frankly our financial strength. If there is a prolonged period of interest rate -- low interest rates, we are unlikely to sacrifice what we consider to be a core tenet of the financial strength of the firm, which is a high liquidity, what we call an internal high liquidity ratio, and therefore an AD ratio unlikely to be getting anywhere near the 90%.

To be quite honest with you, we don't see an option of taking that AD ratio up to the limit of the cap. It's an expression of the conservative way we're going to run the balance sheet, the 90%. It's not a lever that we will play to frankly weaken the financial strength of the firm in order to get some short-term revenues into a particular quarter.

On RBWM, I think the way you've got to look at RBWM is actually through the prism of what we've been doing in terms of the strategic changes to the business. You need to look at RBWM almost on a risk-adjusted basis, because what we have done is we have removed the commission structures that directly rewarded people for selling particular products, both within the wealth management business and in the broader retail bank, i.e., credit cards and mortgages.

That has had an initial negative impact on revenue as actually the staff have adjusted to a balanced scorecard approach. But actually, we believe the quality of the revenue that remains is significantly higher, because we believe that our risk of customer redress and of fines in later periods should have diminished materially as a result of those changes.

So part of the reason why RBWM doesn't have revenue growth is it's the cost of transition from an historical commission for selling a particular product, which I think involved or significantly contributed to the risk of mis-selling, and therefore the customer redress that you've seen go through the banking industry, versus the paradigm that we're now operating under.

So the way to really think about RBWM income, not just for us but for everybody else, is on a risk-adjusted basis; i.e., revenue less customer redress, less fines, less legal fees.

And in terms of the branch network, we've done a chunk of work on effectively are city clusters, because we think now in terms of our branch networks around city clusters within countries, not in terms of networks across a country. And the logic of that is for an international bank like ourselves, the addressable wallet tends to be centered around city clusters.

Or to put it another way, the GDP of a country does not follow evenly across its entire geographic or topographic landscape. It's concentrated around metropolitan and urban areas. And that again will result in some further fine tuning of branch networks.

Lastly, of course, you've got the entire digital space and digital offering which is changing the way that people actually interact with banks and therefore changing the various distribution channels.

Iain Mackay

So if I move broadly on to certain other aspects of the cost equation. There is absolutely no let-up nor absence of opportunity within the firm to continue to realize cost savings of a sustainable and net variety from across our global businesses and into the functions within the firm.

You'll recall that last year, we set a target for sustainable saves of $2 billion to $3 billion for the period 2014 to 2016. In the first quarter of 2014, we've realized $275 million such saves, and there remains within the firm a very strong focus on streamlining and simplification of every business process and supporting function process where there remains significant opportunity to bring the operating model in reality into line with four global businesses and the global functions that support that across the 75 countries in which we operate. So there's a lot that remains open to us.

Stuart Gulliver

And, again, just to give you some points of illustration of that just within RBWM, so we've consolidated the number of Internet banking systems. And you recall I've spoken about this a few times. Remember, we're moving from running the firm at 88 separate banks, which is effectively what Iain and myself inherited in the beginning of 2011, to running it as a single institution with four global businesses.

So within Internet banking systems within RBWM, we've reduced the number so far from 59 to 41. Eventually, we'll get it to 1. You can think about the IT operational and software cost savings that that will actually release.

In terms of products, we've actually reduced the number of front book products in retail banking by 28%, insurance by 24%, and investments by 60%; i.e., because we had all of this diversification or everybody did everything many, many times, there's a phenomenal opportunity to get a much more holistic core set of products which not only again I think, reduces your customer mis-selling risk, but also significantly provides the opportunity to reduce the cost base of the firm, because the more heterogeneous you are, the greater your cost is going to be; or the more homogenous you are, the lower your cost base should be. So all of those exercises are running through.

And then again within RBWM, there's also with the way regulators are looking at it, an exercise about what represents fair value for products, i.e., what should various products be costed at. And again, that results short term in some revenue pressure as effectively things on fees, for example on overdrafts, on credit cards, places like the UK, Turkey, all result in lower revenue, and working through to frankly what we regard as a much more sustainable business model.

And that's what I was really referring about in my opening remarks. We think this actually is in the best interests of our customers and, therefore, long term in the best interests of our shareholders.

You've seen a phenomenon, not just with HSBC but with a number of banks, that profits recorded in year X and then given back in a multitude in X plus 5.

Chirantan Barua

Points taken. Thank you.

Stuart Gulliver

Thanks very much. Okay. Next, please.

Alastair Ryan, Bank of America

I'm trying to picture your margin where there's, I suppose as you'd expect with a big company, lots of moving parts. It looks like Asia's moving better. I think that your comments suggest that BSM may have found some kind of floor but North America looks pretty rotten in the quarter as some of the back books roll off.

Could you give us a sense of whether the ups are trending up and the downs have finished trending down, or whether I'm wrong way up on that, please?

Thank you.

Iain Mackay

That's a great question, Alastair. Look, I think from an overall net interest margin perspective, again, as has been the case for a number of quarters now, the most significant influence in overall net interest margin for the Group is the continued run-off of the CML portfolio in North America.

If you take that out of the equation, I think broadly speaking, if you go through by region, we have certainly at a Group level when you exclude the impact of the run-off portfolio, we've seen some marginal compression on a year-to-date basis when compared to the first quarter of last year or compared to the fourth quarter.

One of the factors that impacts that is actually a point that you brought out at the year-end results, Alastair. When you reflect on the change that we've made in the treatment of repo and reverse repo where the character -- in actual fact, the use and the manner in which we manage those books of business was somewhat altered in the third quarter of last year, which is really reflecting how the book is managed by global banking markets where we've got those classified as loans and advances and customer deposits, and on repo, as you can imagine, the margins are relatively narrow.

So two factors: CML run-off portfolio; another factor, the change in the treatment of the repo book.

The other factors, when you reflect across our Asian business, margins remain stable. I don't think we've seen -- we certainly haven't seen any of the fairly significant compression that we saw in the first quarter of last year.

When you look at Middle East, we've actually seen stability and some expansion; certainly some expansion as asset spreads were improved in that area as well as cost of funds declining.

Latin America; it's broadly speaking -- again, the repositioning of that business where we've moved away from unsecure to much more secure, so again from an asset spread perspective, we've knowingly taken a little bit of a hit on net interest margin.

But again, that goes back to one of Stuart's points which was just reflecting on the overall quality, both within Retail Banking and Wealth Management as well as the lower end of the Commercial Banking business.

So those are really the three main features: North American run-off, the repo book, and some repositioning within Latin America and around.

In Asia Pacific, we've seen broad stability. In the UK, on the asset spread side, it's certainly become considerably more competitive over the course of the last six to nine months. I think probably FLS has an impact, certainly in terms of the cost of funds for some of our competitors in that respect. But by the same token, we've seen some tightening in the cost of funds as well.

So although we've seen some compression in asset spreads in the UK, we've been able to to some degree mitigate that by an improvement in the cost of funding position within that market also.

So the main features are Latin America, repo book and North America.

Alastair Ryan

Thank you. So then just -- as North America shrinks, it ought to -- well, mathematically, it has less impact on the Group margin overall. Are you close to a point, have you reached a point, or are you still distant from a point where it's driving the margin overall?

Iain Mackay

Yes, I think that's right. Look, you've got a total unpaid principal balance now of just less than $30 billion in the run-off portfolio.

Stuart Gulliver

Which is about -- if we remind you, Alastair, that's about one-quarter of what we had in 2008 when it was $118 billion.

Alastair Ryan

Sure, yes.

Iain Mackay

Last year -- well, by the mid-year of this year, we will have disposed of all defaulted subprime mortgages. That's a sales program which has been in process by the team there for the last 15 months or so, which has progressed well.

You'll see some of the results of that just in terms of marginal losses incurred in the disposal of some of those defaulted loans coming through the numbers over the last two or three quarters; not a major impact on the results of the firm.

So, yes, there will be a declining influence as that portfolio runs off, but you will recall that that was a particularly high yielding portfolio. And as those particularly high yield loans continue to dissipate, you'll see less impact but you'll continue to see some impact in the overall net interest margin for the Group. But it absolutely will become less pronounced.

Alastair Ryan

Thank you. And then did I read the BSM comments correctly? Are you suggesting that 750 is the floor?

Stuart Gulliver

Yes. I think the guidance is unchanged. The decline first quarter this year vs. first quarter last year, we did some disposals in the first quarter of last year which basically accounts for almost the entire difference between first quarter 2013/first quarter 2014. So, yes, I think you should assume that kind of 2 1/2 to 2 3/4 is about right.

Alastair Ryan

Thank you.

Raul Sinha, JPMorgan

Can I have two, please? The first one really on the commercial bank where we've got a little bit of growth in the top line, but in Asia, we see you've had a decent rise in PBT. I was wondering if you could give us a little bit more comment on what you're seeing in terms of the margin trends. It looks like margins across China related produced are on the rise. Is that a temporary factor in your opinion, or do you think that we now start to look towards a positive margin dynamic there?

And then secondly, a more technical point, I guess, for Iain. The shareholders' equity is only up $2 billion, despite your $5 billion plus profits. I was just wondering if you could talk about any other drivers there.

Stuart Gulliver

Okay. So first one on CMB. I think margins are basically broadly unchanged. I think it's too soon to say that margins have started to widen out again. I think the extent of the change we'd need to observe for a couple of quarters.

What we have seen in trade finance is probably an end-of-margin compression, but I don't think that we should be talking about margin and spreads widening.

The other places worth looking at in terms of success and progress in CMB is actually in the UK where actually we've grown our term lending about 35% year-on-year. And actually, if you look at the Bank of England March data, we're capturing about 8.1% of new lending in the UK compared to 6.5% this time last year. And actually, our stock of loans and overdrafts in CMB in the UK is up, albeit marginally, but again, looking at a Bank of England statistic that suggests that the overall market's down 1.1%.

So remember, we talked previously about the fact that there's good opportunities in the UK for us to take market share. I think that is starting to happen. And also, in receivables financing, the value there is up about 18% average balances over the same period, again in the UK receivables financing, which again we thought, if you recall, would be receivables financing is kind of for the CMB customer base what debt capital markets is for the global banking, i.e., a way of dis intermediating the banking system which is a bank like yourself. You capture only if you've got a receivables finance or debt capital markets capability. And actually, fortunately, we have both.

So again, you can see in Global Banking and Markets, these results are relatively actually quite strong. We had our highest league table position in debt capital markets in international bonds; Bloomberg, we were first in the first quarter, and with a market share that had increased from 5.5% to about 7.1%. So there's clear signs there of some of the progress that we've talked about.

And I'll let Iain explain where the equity went.

Iain Mackay

Yes. So the main feature in terms of the difference between where you see profit generated is the deduction of the foreseeable dividend. So you'll recall some of the PRA guidance has been that when you report regulatory capital, it's not only the profits reported in the period, but it is a deduction for the foreseeable dividend.

So from that, we've taken away the first interim dividend which amounts to about just over $2 billion. We take account obviously for an estimate of what we would expect to see in terms of scrip netted against that. And then we true up for the actual take-up in scrip against the fourth interim dividend.

Overall in the round, that represents about $1 billion worth of a deduction from the profit generation that we've articulated in the slide.

The other main driver of the reduction is an excess of expected losses over impairment allowances overall within the portfolio. So as an example, we had a significant position with a large corporate client which was restructured within the quarter, and although the allowance for that was eliminated through the restructuring of positions, the position is fair valued, the expected loss doesn't really change very significantly; in fact, it doesn't really change at all; and as a consequence of which what we find ourselves with is an expected loss in excess of allowance for loan losses which increased somewhat.

So you could go into nauseating detail in this, but when you round it out to the main differences, it's the impact of the foreseeable dividends and an excess of expected loss versus impairment allowances.

Raul Sinha

Thanks, Iain. Can I just clarify just on an unrelated point? The decision to not disclose Hong Kong separately, if you could shed any light on that, and if there's anything different in the revenue trend there relative to the PBT trend.

Stuart Gulliver

Hong Kong is actually broken out.

Iain Mackay

It is. So if you go to the tables within -- the geographic tables, it's page 25 of the IMS, we give you a reported profit before tax and the underlying profit before tax. And then on the tables, which we've loaded up to the IR website, we give you a bit more detail on Hong Kong.

Iain Mackay

Yes, the progression in Hong Kong. There's no reason other than the simple fact is --

Stuart Gulliver

It's just the way we manage the Bank.

Iain Mackay

It is. Peter Wong is the CEO for Asia Pacific and he covers Hong Kong and the rest of Asia Pacific. So when you look at Peter and the rest of us are looking at, we'd look at it as Asia. So it's really -- it's rather a technical point in terms of how we allow external reporting to internal management.

Raul Sinha

Okay. Thanks very much.

Chris Manners, Morgan Stanley

A couple of questions, if I may. The first one was on the impairment charges, and obviously very good performance in the quarter. Write-backs in MENA, looked around 9 basis points cost of risk in Europe. Just on how sustainable you see that and whether we should be penciling in that as a very good quarter that the charge was creeping up a little bit from there, or if you think that's a sustainable run rate.

Second question. Thanks very much for what you gave us on the capital there, and obviously debate's evolving; and thanks for giving us the number on Pillar 2A. But I had a question for you on what sort of management buffer do you think that you'd want to run with above your 10.4% stack there. I know Barclays are saying 1.5%, and yet any thoughts around that would be really helpful.

Stuart Gulliver

So I'll kick off on loan impairment charges, and then we'll both have a go at the capital point.

I think that the trend looks to us to be sustainable. We changed very consciously to secured back in 2011, which is partly -- shows up in some of the revenue growth that we've struggled to show, and that clearly has a mirror reflection in lower loan impairment charges.

So there is nothing that we see today that would suggest that this is a low point, high point, however you want to put it. So we think that these reflect what we're seeing in the second quarter and the outlook we have for the balance of this year as it sits today.

Clearly, from time to time, there's idiosyncratic risk that we can't really allow for, obviously, but we've got nothing on the radar screen in that regard either.

So no, I don't think that this is necessarily a one-off quarter. What is obviously pleasing is that we haven't seen a repeat in this quarter of further loan impairment charges, either in Brazil or in Mexico, which if you recall were fairly predominant in the second -- in the third and fourth quarter of last year.

Iain Mackay

Yes, Chris, just if you reflect on credit costs as a percentage of the average outstandings, first quarter of last year 46 basis points; first quarter of this year 32 basis points.

As Stuart mentioned, the second and third quarter of last year was impacted largely by Brazil and Mexico where we saw a tick-up to 77 basis points and 64 basis points respectively, and then the fourth quarter of last year 44 basis points.

So you normalize for the impacts of Brazil and Mexico on which we disclosed a great deal of information during those periods last year, you've got a pretty stable credit cost floating around the 40 basis points mark.

Chris Manners

Thanks.

Iain Mackay

Capital, management buffer. I think as we mentioned, when you look at the array of regulatory required buffers embedded, whether it's from a GSIB perspective or from a capital conservation perspective, which I think we do -- well, we believe we've got clarity on it and there was actually some pronouncement from the PRA last week which is somewhat helpful in terms of how they'll be phased in from January 1 2016 onwards. We've obviously disclosed Pillar 2A, of which 56% is covered by common equity Tier 1 which represents about 87 basis points for us.

In terms of how the wider capital buffer regime as it relates to counter-cyclical or capital sectoral requirements or the PRA buffer, I am afraid to say that that remains somewhat unclear, and any guidance from the PRA in the last few days really hasn't cleared that situation up at all for us.

So when you reflect on the overall capital strength, the capital generative ability of the Group, the extent to which we will carry a buffer, at least for the foreseeable future is really to deal with very short-term volatility driven principally from foreign exchange across the range of activities which we do.

So again, if you reflect on the impact on our capital ratio this quarter from foreign exchange movements where you certainly saw significant weakening of some currencies against the dollar, like the real, the Argentine an peso, you saw strengthening of sterling against it, the impact on capital actually was less than 1 basis point this quarter, so not a significant feature.

And even if you track back through the last four or six quarters, I think the most significant impact we've had has been about 30 basis points. So in that regard, we don't really think we'd carry more than 50 basis points as a management buffer dealing with that short-term volatility within our business.

In terms of longer term we, I'm afraid to say, are going to be incredibly boring and say what we've said over the preceding few quarters is that until we get greater clarity around how the PRA intend to implement upcoming RTS and ITS from the EBA, the sectoral capital requirements, counter-cyclical, we're going to sit tight and just manage with the stacking that we've shown in the last page here.

We're obviously sitting at an end point 10.8%, well ahead of where the capital requirements are today, and continue to generate capital through operations.

Stuart Gulliver

And also, bear in mind we've got an ROE of 11.7% with obviously a higher capital ratio than when we set out the 12% to 15% target which was based off 10%.

Chris Manners

Thanks. That makes a lot of sense. Could I ask one follow-up which is are you expecting any more pro-cyclical model change in positions from the PRA, or HKMA, or any of your regulators? Because, I guess things like that 30 basis points on the LGD floors, if anything like that was to come out of the woodwork that may slow the progress. Is there anything that we should be aware of there, or are you pretty happy for the moment on the models?

Iain Mackay

I think as it relates to HSBC idiosyncrasies, I think the first quarter LGD floors that you saw implemented across principally our corporate and banking exposures in Asia and Europe, we don't have line of sight to anything else as it relates specifically to HSBC at this point in time.

I think what we're all waiting or perhaps wondering about is as the London or the south east of England property market continues to move ahead, will the FPC and the Bank of England reflect on how they may wish to put some controls around lending within that sector. So that's something that I don't think anybody's got line of sight. It's obviously one of the things that the Bank's going to think through.

Industry-wide features that are out there that I'm sure you're aware of, Chris, is the development of the PVA and then the RNIV, which again are prudential filters that are going to be implemented on capital over the course of coming quarters, but how that is going to be done remains unclear at this point.

Stuart Gulliver

But again, even if, going back to Iain's point about the property market in the south east, it's worth bearing in mind that the LTV on our book is incredibly conservative.

Iain Mackay

What we have seen in Hong Kong, obviously, was a 15% RWA with a floor on new originations in Hong Kong which we saw implemented in the early part of last year. In Hong Kong, spread across the wider market, that measure probably works. When you reflect on heat in the market, particularly in the south east of England, measures such as that applied broadly to the UK economy perhaps would not be the best way of managing it. But again, that's the challenge for the Governor of the Bank of England.

Chris Manners

Okay. Thanks very much, guys.

Ronit Ghose, Citigroup

Just a couple of questions, first of all on GBM. The revenue performance, as you've alluded to, has been very good relative to your peers, and I had a question regarding the geographic distribution, because I understand the business mix difference to the likes of, say, the Barclays of the world is you have more corporate client business which is very more sticky and stable.

And, Stuart, you referred to gaining market share as well. Could you just talk a little bit more around those topics? Because when I look at the GBM breakdown you give us on page 21, Asia is relatively stable, Middle East is stable. North America and Europe are down, but I'm guessing the big year-on-year delta Q1 on Q1 in DVA and BSM gets booked in Europe and North America. So if I strip those out, it looks like Europe and North America would be relatively stable year on year.

Is that, A, a correct assumption? And, B, if you could just comment around some of the underlying trends here, because it does look relatively speaking very good.

Now second question was on the comments around margin stabilization and particularly around cash and trade. If I look at the CMB revenue break-up by line item, it still looks like the trade receivables -- the trade finance line has gone down Q on Q in revenue terms. And given there's a bit of volume growth there, it looks like there's margin pressure. I just wanted to combine that with your earlier comments about margin stabilization. Is that margin stabilization in Asia and still margin pressure elsewhere?

Thank you.

Stuart Gulliver

Okay. So picking up on trade piece, yes, it is actually -- what you've got is higher average balances but some spread compression resulting in basically an unchanged revenue.

So if you look at trade finance across both CMB and global banking markets, revenues in the first quarter were about $873 million, and in the first quarter last year were $866 million. So it's basically flat with higher volumes, but with a little bit more spread compression. And that spread compression, you're right, is in Europe. In Asia, it has bottomed out.

But obviously the recovery of the banks in Europe, some of the funding for lending schemes, etc., have resulted in some margin compression, particularly in, for example, the UK.

So overall, it's a flat revenue number coming from overall higher volume, slight spread compression in Europe, no further spread compression in Asia Pacific.

In terms of global banking markets, page 21 of the IMS actually breaks it out by geographic region. So you can actually see Europe, Asia, Middle East, North Africa, North America, Latin America, and you'd be right to say that first quarter last year/first quarter this year, what you've got is a decline in Europe, a slight decline in Asia Pacific.

Ronit Ghose

Absolutely. Yes, that was my question, Stuart, that there is on the surface a decline in Europe and North America, but then looking at the product line items, and BSM and DVA are the big declines year on year. So I'm guessing those are in Europe and --

Stuart Gulliver

Yes, they are.

Ronit Ghose

They're in Europe.

Stuart Gulliver

Yes, they are.

Ronit Ghose

So if I take that out, Europe looks pretty flat, stable.

Stuart Gulliver

Yes, it does. Although what I would point out though is, obviously, there is a seasonality to this business, and there always has been a seasonality where the first quarter has always been frankly the strongest quarter of the year.

Now even though the first quarter is weaker than the first quarter of last year, we still expect that seasonality to exist. Okay? So as I say, do not assume that the seasonality has gone away or changed, so therefore, we would still expect second, third and fourth quarters to be lower than the first quarter.

Iain Mackay

Just a small clarification there, Ronit. The BSM is managed across all the geographies because it reflects how we manage the commercial surplus for the Firm. So BSM tends to crop up to a greater or lesser extent in each of the regions. The majority of the impact sits between North America and some in Europe.

But one of the main features in Europe is the DVA, and our main Global Banking and Markets center is sitting in London; the majority of DVA is reflected within the European business. And quarter over quarter, there's a very significant movement sitting in -- adverse movement sitting in Global Banking and Markets in the first quarter of this year versus the same quarter last year.

Ronit Ghose

Absolutely. Adjusting for DVA, it looks like a reasonably pretty good quarter in Q1 in Europe. And just to follow up on the point in your outlook comment in April. Was that specifically about --? The client activity being muted was that about GBM, or was that more broadly where you were you talking about something outside GBM?

Stuart Gulliver

No. It was more about GBM, actually.

Ronit Ghose

Okay. Great. Thank you.

Stuart Gulliver

So what we would think is that the second quarter is going to be more in line with the second quarter of last year.

Ronit Ghose

Okay. Great. Thanks.

Rohith Chandra-Rajan, Barclays

I have a couple as well, please, if that would be okay. Firstly, just putting together some of your comments around the LatAm business, you commented on a move to more secured lending which we're actually seeing, I guess, across the region, and that impact on the net interest margin. And you were talking stability I guess globally in terms of the impairment outlook. I was just wondering what your expectations are for the risk-adjusted margin in LatAm, so net interest income less provisions over loans.

Iain Mackay

I think we'd probably go back to our comments right at the beginning in terms of looking at a region where revenues are probably under a little bit more pressure than anywhere else is certainly a reflection in Latin America.

I think it also reflects, to my earlier comment, that we actually saw some spread expansion within the Latin American businesses. That is largely a factor of lower cost of funds as opposed to spread, asset spread expansion.

Overall, we're seeing asset spreads reasonably stable within that region and a continued ability to manage the cost of funds reasonably well. But the concern is perhaps more so on the volume front within the Brazilian and Mexican businesses.

But what you really need to focus on is that we introduced a new incentive framework for retail banking wealth management, and that had a significant impact on Retail Banking and Wealth Management revenues, particularly in Brazil.

We also, if you recall, had some requirements to raise additional provisions last year in relation to CML portfolios in Brazil. We had specific credit charges against the homebuilders in Mexico. And, of course, we've had a significant de-risking program going on in Mexico related to the Deferred Prosecution Agreement; and also in Brazil in a defensive move there.

So if you look at that de-risking combined with the impact of the incentive framework, they both have had an impact effectively on revenues in Latin America.

Coming through 2014, we're now back to building up assets, but obviously what we're looking to do is to build up assets in lower risk portfolios which are bound to have lower margins. But we would expect to have balance sheet growth over the remainder of 2014 in both Brazil and in Mexico.

Rohith Chandra-Rajan

Okay. Thank you very much for that, which sort of links to my second question, actually, which is just in terms of volume growth expectations, I guess for RBWM particularly.

So in GBM and CMB, we've seen volume growth. RBWM you've talked about a little bit in terms of what's happened historically. Just wondering about two things actually. One is the pace of CML reduction from here in North America, and then also if you could elaborate a little bit more about your expectations for the retail businesses across the regions. You've already covered LatAm.

Stuart Gulliver

Yes, sure. Look, bear in mind in retail banking, we've gone effectively from 65 countries to 45 countries since 2010 in terms of where retail banking is concentrated, and it's really concentrated primarily within 19 countries. Remember, this is the business that's actually seen the most business exits, and country exits actually, of the restructuring that we've done.

Now it's also the case that I think that the conduct risk environment has changed the extent to which frankly any bank, not just us, can look for substantial growth from wealth products, because we think the conduct risk agenda, as I said earlier, has significantly changed, which is why we changed our incentive schemes away from specific commissions for selling specific products to a much more generic scheme.

That also means that we will be looking to build revenue up by building our lending business up in Retail Bank and Wealth Management, which has obviously a bit of a lag on it. But we would expect that actually during the course of the year that we will be adding to the loans and advances line in Retail Bank and Wealth Management and that we'll have a higher balance at the end of the year than at the start of the year.

What we're doing there though is not going down the credit curve. What we're looking to do is to take an increased market share in frankly the kind of customer groups that we bank in Premier and we bank in Advance. So we're looking for bigger market share and an unchanged credit risk.

And so don't interpret this as actually a significant deterioration in credit risk at all, but there is a push therefore into taking additional credit risk in Retail Bank and Wealth Management.

Iain Mackay

On the CML question, sitting at a bit less than $28 billion in terms of unpaid principal balances, we I think at last year's investor update, we talked about having that unpaid principal balance probably down below $20 billion by the end of 2016. I think based on the rather efficacious manner in which the US team has been able to sell off defaulted loans this year, our current expectation is that we would expect to surpass to quite a significant degree that.

So run-off at the moment, excluding asset disposals, probably sits somewhere between $3.5 billion and $5 billion per annum. So getting down to below -- so in the range of $17 billion to $16 billion by the end of 2016 seems well within range for us.

Rohith Chandra-Rajan

Okay, that's great. Thank you. Could I just clarify actually Stuart's comment on growing the RBWM business? Is that net -- that's including the CML run-off, or is that the principal business?

Stuart Gulliver

That's the principal business; CML run-off put to one side. There's no point in giving you a net number. One is an absolute exit and the other is basically a gear-up in effectively taking secured and unsecured credit risk, but as I say, without a deterioration in the credit quality; i.e., looking at building up our market share to frankly lending to our chosen market segment.

Rohith Chandra-Rajan

Okay. Thank you very much.

Manus Costello, Autonomous

I had a question on capital and a question on retail, please. On capital, you gave the commitment about 12 months ago to think about buying back the scrip dividend. There's obviously the uncertainty now around the buffer positions. I wondered if you could clarify what you think your timing will be on when you can give us an update on whether or not you're going to push ahead with that scrip neutralization and any other capital return.

And on retail, you referenced that -- you discussed the revenue weakness in reference to various changes in incentivization which have been made. I understood that those have been made for some time. And I'm just looking at the quarter-on-quarter progression of retail Q1 on Q4 and there was quite a step down, even adjusting for the Panama sale. So I wondered if there was anything specific which came in in Q1, or if this is just the cumulative impact of changes you made through 2013.

Stuart Gulliver

So in Q1 of last year, we removed specific incentives on product sales for wealth management. In Q1 of this year, we extended that change to the rest of retail banking; so credit card sales, mortgage sales, etc. So there absolutely was a second phase in the first quarter of this year.

Now, all of Retail Banking and Wealth Management are off individual commissions for selling individual products, whether it's a credit card, a unit trust, an insurance product or mortgage. They're all on balance score cards.

So, yes, two phases; first quarter of 2013, first quarter of 2014.

And on the capital question, frankly, the answer is once we know from the PRA what our end state core equity Tier 1 ratio is, then we can address other issues, because they're all a subset of the same question.

Iain Mackay

So to your point, Manus, the story on the scrip, in actual fact, hasn't changed since the day we announced it, which was we would consider script buyback, 1, meeting regulatory capital requirements, which clearly is a source of some frustration to the industry and the investors in the industry at the moment; 2, not seeing the opportunity to invest capital surpluses at a return equal to or greater than that targeted to lead into development of the firm overall and to increase the dividends.

So until -- the principal criteria around that is clarity in the capital management. The second criteria is always assuming that we'd per se run out of investment opportunities that were attractive to us.

Manus Costello

Okay. Thanks. Just a very quick follow-up on capital. Iain, you've mentioned before the possibility of reclassifying BoCom as a material holding rather than proportionally consolidating. I wondered if you could give us an update on whether you're going to do that and what the capital benefit would be to you of doing that.

Iain Mackay

No. There wasn't really discussion around from an accounting perspective. It will continue to be accounted for under the equity method of accounting as an associate. So as it's presented in the financial statements, should we find ourselves in the position later this year of actually having the value in use falling slightly or falling significantly below the carrying value of the firm, then what we would be doing was in effect de-recognizing our share of net earnings or the net assets, if you like, of BoCom.

But it's not a deconsolidation or a change in the fundamental accounting treatment. It's a consistent application of equity accounting when reflecting on the valuation of BoCom both against market value and value in use.

From a reg capital perspective, there's absolutely no change. So from a reg perspective, we will continue to proportionally consolidate the risk-weighted assets which are generally calculated in a standardized basis for BoCom, and continue to proportionally consolidate our share of revenues and profits from that firm.

Manus Costello

I thought you'd said at Q4 that you were considering moving it across. Anyway, we can follow up on Monday perhaps.

Iain Mackay

So there was some consideration of that, but in discussion with the PRA, they didn't seem amenable to that approach.

Manus Costello

Understood. Thank you.

Martin Arnold, Financial Times

I just wanted to ask for a bit more clarity on the challenging market conditions, in particular in the Global Banking and Markets business.

And also, to talk about your -- if you could just talk about your resolution planning, and whether you're still planning to go for a multiple points of entry model, or a single point of entry model, which the UK regulator seems to prefer.

Thanks.

Stuart Gulliver

We will still be going for a multiple point of entry model, so there's no change there.

Martin Arnold

Even though the UK regulator seems to prefer a single point of entry?

Iain Mackay

I'm not quite -- well, you need to speak to the regulator about that, but our discussions with the PRA and the Bank of England are very much focused on the appropriate methodologies for resolving HSBC, and being a firm that's organized through 64 separately capitalized and funded operating banks around the world under separate supervision by regulators in those jurisdictions and a holding company -- and that is what HSBC Holdings plc is a holding Company, it's not a banking entity with branches all over the world -- MPE would seem the eminently sensible way to approach resolution.

Stuart Gulliver

And to be honest, Martin, we've never had a conversation with the Bank of England or PRA on any other basis.

Martin Arnold

Okay.

Stuart Gulliver

And on market conditions, well, you saw basically our revenues in the Global Banking and Markets were down basically a couple of percent, if you put aside the decline in balance sheet management. So we had a reasonably good first quarter, although it was weaker than the first quarter of last year. I would expect the second quarter of this year to be slightly weaker again.

Last year, the second quarter in Global Banking and Markets was a PBT of around $2.1 billion. First quarter of this year was $2.8 billion. I would have thought the second quarter of this year will be down towards that $2.1 billion type of level, A, because conditions are tricky, which I think they are for most people; but, B, because there's a seasonality to our business which normally results in the first quarter being the strongest quarter of the year and tends to have been -- clients hedge in the first quarter, etc.

The other thing I think that's different for us is the -- what everyone else terms FICC is only actually about 25% to 30% of our Global Banking and Markets PBT anyway. So don't forget, we have a very large payments and cash management business, very large trade finance business, very large lending book, very large custodian business, and so we are less exposed to FICC type of activity than others.

And within that FICC line, yes, we saw declines, and Iain talked about them in his opening remarks, in foreign exchange, credit and rates, which were kind of the order of 8%, 12% and -- I forget what the other one was, 20% or something. And I think that that kind of structural stuff exists in the marketplace but it will have a more muted impact on us.

And of course then also bear in mind that our business is very much pushed towards clients; has a large emerging market piece in it. And that's not to say extreme volatility, but rather a lot of end user clients. And we never had a large structured derivative book so we weren't really ever in that part of the business that effectively has gone away, either because regulations forced it into exchanges and therefore has removed a lot of the margin. We didn't have that to lose, as it were.

So I think there's greater predictability towards our business, but I do think the second quarter will be somewhat weaker than the first because it kind of always is. As I say, there's a seasonality to our business which goes around frankly clients, because clients tend to start the new year and hedge stuff in their first quarter.

Martin Arnold

Okay. Thanks very much.

Stuart Gulliver

Thanks, Martin. So we've got time for one last question, please.

Billie Lao, Apple Daily

I have three quick questions; first one; the margin. As you mentioned, there's still no signs for net margin widening. Is it fair to say that the momentum for your core business and bottom line to grow is still very weak?

And secondly, a follow-up, a quick follow-up on BoCom. How likely is the possibility of making impairment for BoCom this year as value in use has been lower than carrying value, as you explained earlier?

And finally, I'm wondering if you would like to share the view on the yield curve which is most likely to trend up than trend down. So if you share the yield, say, by the end of the year, 10-year treasury yield curve is around 3%. So to what extent would it affect the GBM business, the yield gapping business, and the bottom line growth of the Group?

Thank you.

Stuart Gulliver

So we don't expect short-term rates to rise during the course of this year in any currency. So therefore, we don't really anticipate a significant change in balance sheet management. We still think balance sheet management will make $2.5 billion to $2.75 billion. And there won't be fresh opportunity there until short rates go up. And actually, the opportunity will then come through in the Commercial Banking and Retail Banking and Wealth Management lines actually from the greater value of those deposits. But I don't see that happening during the balance of 2014.

The slightly increased curvature enables us to keep alive the net interest income within balance sheet management at the $2.5 billion to $2.75 billion level, so it probably doesn't produce an opportunity to increase it from there.

On the margin, the thing that you've got to do with the margin is extract the run down CML portfolio in the United States, because it has a very big margin on it. As we run it down, that very big margin goes. But of course, remember, Billie, it also had massive bad debts. So there are two things coming off different parts which creates a distortion.

As we run down the CML book, it does cause the margin to compress, but that really says nothing about our go-forward business in Global Banking and Markets, retail banking, Commercial Banking. Actually, what you can see is the much improved loan impairment charge line as we've run that book down. So that book affects two parts of the accounts. It reduces the net interest margin but also improves the loan impairment charges.

If you look underneath that, yes, the net interest margin is stable. There is no sign of it improving but it's stable. And actually, it's also going to be a factor of where we are within the interest rate cycle, but it remains a challenge.

And on BoCom, I'll let Iain deal with it, because it's a highly technical accounting issue.

Iain Mackay

Not really. The timing remains the same, as we discussed about at the end of the year, Billie. We would expect, just based on the historical trend of profits accruing within BoCom and our share of that across the first half of the year versus what we see happening in the value in use model which is a much longer-term valuation view of BoCom, we would expect that impairment to occur probably somewhere towards the end of the second or into the third quarter.

Now I will caveat that because it obviously depends on performance within the value in use model, which is dependent on a number of assumptions that underlie that. But it also is very directly dependent on the performance and the operating results of BoCom. But if everything were to remain reasonably consistent with what we see at the end of last year and through the first quarter of this year, we'd expect that accounting effect to occur some time in the second or third quarter.

Billie Lao

Okay. And on yield curve and its impact on GBM and overall income?

Stuart Gulliver

No. Look, as I said earlier, I don't think interest rates change this year. So the effect of the yield curve, or the steepening of the yield curve, is the reason why we think balance sheet management will still make $2.5 billion to $2.7 billion. I don't expect that the steepening of the yield curve would have a particularly significant impact on GBM's profits.

We had good first quarter in our Global Banking and Markets business, compared to the street, so although our numbers were weaker than the first quarter of last year, compared to others, remember, our revenue excluding balance sheet management was down basically about 1%, which is actually a materially strong performance.

That's always the best quarter of the year, the first quarter for GBM, so we would expect subsequent quarters to be a bit weaker. But there's nothing in particular I would point out that frankly informs a new item that changes the outlook for that business.

Stuart Gulliver

Thanks very much, Billie. Okay. So that brings the call to an end. Thank you everyone who's joined on the call. Thank you very much.