Edited Transcript
Interim Results 2013
Presentation to Investors and Analysts

5 August 2013, 11.30 am GMT

Corporate participants:

Douglas Flint, Group Chairman
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Douglas Flint, Group Chairman – Introduction

Good afternoon from here in Hong Kong. Good morning to everyone in London. Welcome to our 2013 HSBC interim results conference call. With me in Hong Kong is Stuart Gulliver, the Group Chief Executive, and Ian Mackay, Group Finance Director.

Before we start, I'd like to say a few words on behalf of the Board. We consider that HSBC delivered a solid financial performance in the first half of 2013. These results confirm the value which is being delivered from the continuing reshaping of the Group, and from enforcing appropriate cost discipline.

You'll note the Group's capital position has strengthened further during the half. The core Tier 1 ratio improved to 12.7% compared with 12.3% at the beginning of the year, and 11.3% a year ago. Supported by these results, and as indicated in the 2012 annual report, the Board has declared a second interim dividend of $0.10 per ordinary share. This takes the total dividends declared in respect of the first half of 2013 to $0.20 per ordinary share, which is some 11% higher than the comparable period in 2012.

I'll now hand over to Stuart to talk you through the highlights for the half, and then Ian will take a more detailed look at performance. Stuart?

Stuart Gulliver, Group Chief Executive – Key points

Thanks, Douglas. I'll start by pulling out the key points from these results. Reported profit before tax was $14.1 billion in the first half, up 10% on the same period in 2012. Underlying profit before tax was $13.1 billion, an increase of 47%. The return on average ordinary shareholders' equity was 12%, up from 10.5% in the first half of last year.

We continue to make progress on delivering our strategy. We grew revenues key areas in the first half, led by our Financing and Equity Capital Markets and Credit businesses, residential mortgages in both our home markets of the UK and Hong Kong, and from increased collaboration between our global businesses, where collaboration revenues grew by 5%.

We also continue to pursue our strategic aim of improving costs in order to reinvest in the business, achieving an additional $0.8 billion of sustainable cost savings during the first half. This then takes the annualized total to $4.1 billion since the start of 2011, exceeding our target for the end of this year, 2013.

We also continue to reshape HSBC. In March, we sold a $3.7 billion Non-Real Estate Personal Loan portfolio, accelerating the runoff of the Consumer and Mortgage Lending portfolio in the United States, where we continue to refocus our business. And we've announced the disposal, or closure, of 11 non-strategic businesses since the beginning of this year. That brings the total of transactions announced since 2011 to 54. The rate of such transactions will now slow, as the first phase of strategic delivery draws to a close.

These steps have released $80 billion in risk-weighted assets on completed transactions, with a further potential release of around $15 billon to come. This will support investments in organic growth opportunities that are aligned with our strategy.

This next slide shows the financial highlights. The main points to focus on here are the ratios. Cost efficiency improved to 53.5%. The return on equity was 12%; the advance to deposit ratio remains robust at 73.7%. And as Douglas indicated, we remain one of the best capitalized banks in the world, with a core Tier 1 ratio of 12.7%, and a common equity Tier 1 ratio of 10.1% on an endpoint basis. We are, therefore, well positioned with respect to the implementation of Basel III.

Turning next to slide 5, and this is an important slide. The long-term trends which underpin our strategy, the rebalancing of the global economy, and the relative growth of trade and capital flows versus GDP growth remain intact. There has been a slowdown in the faster growing markets in recent quarters; even emerging markets go through business cycles. This has impacted our revenue and profit growth, but the reality is that those markets continue to grow relatively quickly. HSBC remains well positioned with strong market shares across these faster growing economies.

You can see the profit contributions by geography on this slide. Underlying profits were higher than in 2012 in five out of the six regions. In Hong Kong, profit before tax for the first half was $4.2 billion, up 13% on last year. This was driven by growth in Global Banking & Markets, in part reflecting higher collaboration revenues with Commercial Banking.

In the Rest of Asia-Pacific, profit was $3.9 billion, and we have taken actions to strengthen our position in most of our priority markets across the region, as we continue to execute the strategy. For example, we continue to grow our branch network in Mainland China, with 149 branches today, up from 141 at year end. And we maintained our market leadership in renminbi business, as reflected in our number one position in the recent Asiamoney Offshore Renminbi Poll.

In Latin America, profit was down $500 million as loan impairment charges rose. In Europe, profit was up $1.8 billion, due to lower customer redress provisions, improved performance in Global Banking and Markets, and growth from higher mortgage lending in the UK.

In North America, profit there was up $1.6 billion, due mainly to a decline in loan impairment charges in the US of $1.1 billion, notably in the runoff portfolio, reflecting the general rally in house prices in the US. And also from lower costs, due to the non-recurrence of provisions for fines and penalties recorded in the first half of 2012.

The table on the right shows our profit performance in each of our top 22 markets. So let's take a quick look at a few of these markets.

In Hong Kong, we recorded strong growth compared to 2012 for reasons I've already mentioned. In Mainland China, revenues fell, compared to last year. But though the GDP growth rate has slowed, we should not forget that, over the three-year period from 2011 to 2013, the Chinese economy is estimated to have grown by over 25%.

In India, lower rates during the half reduced interest income, and fee income was down due to a decrease in mutual fund and insurance sales as we deliberately reposition the business. And in the UK, the modest economic growth supported a good performance as we increase residential mortgage balances and our support of export-oriented SMEs.

In the US, against the background of a significantly restructured business, the benefits of economic growth started to show in the substantial reduction of loan impairments in our runoff portfolio.

In Brazil, profit was down due to lower Global Banking and Markets and Commercial Banking revenue and higher loan impairment charges as we increased loan loss allowance coverage on restructured accounts. However, this was partly offset by an improvement in the underlying credit quality in the remaining book.

In Mexico, profits have been affected by higher loan impairment charges, and we continue to reposition the business in Mexico during this period to implement global standards. Implementing these global standards across the Group will us a distinct competitive advantage, and will significantly improve the quality and reliability of our profit before tax.

But, as I indicated at the investor update in May, taking these actions will result in a higher investment spend in risk and compliance and will, therefore, constrain revenues as we exit certain businesses.

Next, I'll I run through the results as broken down by our four global businesses. In Commercial Banking, we achieved a profit of $4.1 billion, up 4% on 2012. We continue to grow transaction banking and trade finance, where we're already recognized as the global market leader.

By leveraging the strength of our global network, we have driven business growth. Overall cross-border revenues grew, particularly China outbound revenues from corporate customers. And we also recorded lending growth of over $9.5 billion, primarily in term and trade-related lending.

We also launched additional funds to small and medium sized businesses in the UK, in France, and in Mexico totaling $10 billion, targeted at those customers who want to grow their businesses internationally.

Meanwhile, in Global Banking and Markets, profit was $5.7 billion, up 20% on 2012, as revenues rose in the majority of our business lines, particularly in the Financing and Equity Capital Markets, Credit, Equities and Foreign Exchange.

Turning now to Retail Banking and Wealth Management, profit there was up by $2 billion. This was driven by mortgage lending growth in both our home markets of Hong Kong and the UK; lower loan impairment charges in the US runoff portfolio; and also lower customer redress provisions in the UK.

Finally, in Private Banking, profits fell by $300 million, reflecting the loss on reclassification of our Monaco business to held for sale. Overall, of course, we remain committed to our Private Banking business.

I will now hand over to Iain to talk through the financial performance in more detail.

Iain Mackay, Group Finance Director – Financial performance

Thanks, Stuart. This slide shows the reported results. Let me highlight a few key points. Reported revenues were down, compared to the first half of 2012. This was driven by lower net gains from disposals, mainly as 2012 included a gain from the disposal of the US Cards and Retail Services business of $3.1 billion.

Operating expenses were down $2.8 billion, mainly reflecting the non-recurrence of a provision for US anti-money laundering, Bank Secrecy Act and Office of Foreign Currency asset control investigations; lower charges relating to the UK customer redress programs; and lower restructuring costs; loan impairment charges improved significantly, particularly in the US, where we continue to run off the Consumer Mortgage and Lending portfolio.

As you'd expect, the contribution from associates fell, as a result of the sale of our shareholding in Ping An last year and the reclassification of Industrial Bank as a financial investment.

More detail now in the underlying numbers, as it's on this basis that we measure performance. Underlying revenue was up $1.2 billion, or 4%, compared with the first half of 2012. Loan impairment charges were down $1.3 billion, or 29%, and operating expenses were down $1.6 billion, or 8%.

This performance, higher revenues, lower loan impairment charges, and lower costs, meant the underlying profit before tax was $13.1 billion, up $4.2 billion, or 47%, compared with the same period last year.

So let's take a look at what drove those movements. Focusing on revenue, the underlying revenue for the half was $33.3 billion, up $1.2 billion on 2012. As I noted in our call at the first quarter, this includes a net gain recognized on the completion of the sale of our remaining investment in Ping An of $600 million; a favorable debit valuation adjustment of $500 million in Global Banking and Markets; foreign exchange gains and sterling debt issued by HSBC Holdings of $400 million; and other movements listed here, which decreased revenue by $400 million.

In addition to these items, there was also a net favorable fair value movement in non-qualifying hedges of $800 million in the first half of this year.

Taking each of the global businesses in turn, in Commercial Banking, revenue was $100 million higher than in 2012. This was, in part, due to balance sheet growth, primarily from term and trade-related lending, which was largely offset by some spread compression.

In addition, revenue also benefited from increased collaboration with other global businesses, particularly with Global Banking and Markets in Hong Kong.

In Global Banking and Markets, revenue was $100 million higher than in the prior year as we increased revenues in most of our businesses. However, as expected, balance sheet management revenue declined as proceeds from the sale and maturing of assets were reinvested at lower prevailing rates, coupled with lower gains on the disposal of available-for-sale debt securities.

And although our rates business reported a resilient performance, revenue declined in comparison with the first half of 2012, which benefited from Central Bank market intervention.

In Retail Banking and Wealth Management, revenue was $300 million lower than in 2012. This was primarily due to our US runoff portfolio, as balances continued to decline, combined with the $300 million loss on the sale of the Non-Real Estate Personal Loan portfolio, and a $200 million loss from the early termination of cash flow hedges.

However, partly offsetting this, we saw increased revenue from higher mortgage volumes and wider spreads in our home markets of the UK and Hong Kong. We also achieved higher investment product sales in Hong Kong as we continued to grow our Wealth Management business.

In Global Private Banking, revenue was down $100 million. This reflected lower net interest income as proceeds from the maturing of assets where we invested at lower prevailing rates, and spread on assets and liabilities narrowed.

In addition, negative net new money was mainly affected by the adoption of new compliance in tax transparency standards, and actions take to reposition our client base.

Turning to operating expenses; we continue to exercise strict cost discipline and recorded another $800 million of sustainable cost saves during the half. This takes the annualized total to $4.1 billion since the start of 2011 as we continue to release funds to invest in the growing parts of our business in line with our strategy.

Overall costs were down $1.6 billion, or 8%, compared with the same period last year. This mainly reflected the non-recurrence of provisions for fines and penalties recorded in the first half of last year, lower charges relating to UK customer redress programs, and lower restructuring costs.

Excluding these items, costs increased by 2%, largely due to a series of one-offs. In particular, we saw increased litigation-related and regulatory costs, including higher litigation costs in Global Banking and Markets, relating to Thema International Fund plc settlement, and operational risk provisions in Global Private Banking in Europe, and a customer remediation provision related to our former US Cards business.

We also increased spend in strategic initiatives and infrastructure, and continued to invest in our Global Standards governance programs, to which Stuart already referred.

The cost line benefited from an accounting gain arising from changes in the manner in which we deliver employee benefits in the UK, and lower performance-related pay, although this was partly offset by wage inflation. We achieved a positive jaws of 12% for the period.

Turning to credit quality, underlying loan impairment charges were down $1.3 billion, or 29%, compared with the first half of 2012. We saw declines in the majority of our regions, notably in North America where loan impairment charges fell by $1.1 billion. This primarily reflected improvements in the US housing market, the continued run off of our US Consumer Mortgage Lending portfolio, and lower delinquency levels. These factors were partly offset by an increase in Latin America. This was notable in Mexico, as

Stuart mentioned earlier, and in Brazil, where we increased loan loss coverage on restructured accounts in Retail Banking and Wealth Management, and business banking and commercial banking. However, following the policy changes we made in 2011, the credit quality in the remainder of this book has improved.

The Group's core Tier 1 ratio of 12.7%, compares to 12.3% at the end of 2012. This reflects strong capital generation from a profitable business which also enabled us to pay $4.8 billion in dividends during the first half. Though regulatory changes slightly impacted the numbers, management actions in respect of the sale of our shareholding in Ping An, the reclassification of Industrial Bank as a financial investment, and the ongoing reduction of the US runoff portfolio, helped to improve the capital position.

The Basel III common equity Tier 1 ratio on an end-point basis was 10.1% at the end of the half. We are well positioned with respect to implementation of CRD IV. And HSBC remains one of the best capitalized banks in the world, providing capacity for both organic growth and dividend return to shareholders.

The strengthening of our return on equity from 10.5% to 12% is primarily due to strong profit generation, net of dividends, combined with minimal movements in the fair value of own debt, compared with adverse movements of $2.2 billion in the first half of last year; lower UK customer redress charges; and the non-recurrence of provisions for fines and penalties.

As a Group, our current return on risk-weighted assets stands at 2.6%; on an underlying basis this is 2.4%; and when one excludes the runoff portfolios, it's at 2.8%.

Provisioning of the Group towards the faster growing markets is reflected in the distribution of risk-weighted assets. And the geographic distribution of profit is showing a more normalized pattern compared to 2012.

I'll now hand back to Stuart.

Stuart Gulliver, Group Chief Executive – Outlook

Thanks, Iain. Before we take your questions, a quick word on the outlook. There are signs of improvement in the UK, and in the eurozone, and the US economy continues to grow reasonably well. It does, however, seem to have been forgotten, in the last few weeks, that faster growing markets also experience business cycles. Despite slower growth in the short term, the longer-term trends in the global economy are unchanged.

First, growth in trade and capital flows will continue, both between mature and faster growing markets, and also along the so-called south-south trade routes, which connect faster growing markets to one another. With our network across 80 countries and territories, we're well positioned to take advantage of this growth.

Second, led by China, faster growing markets will pay an increasingly important role as the global economy continues to rebalance. And these are the markets in which we have a significant and longstanding presence.

So to close, as you can see from these results, we've made further progress on delivering our strategy in the first half of this year. And in May, we set out the next phase of delivery covering the period from 2014 to 2016. As you know, our strategic direction is unchanged and our priorities are clear; to grow both the businesses and the dividends; implement the highest global standards of conduct and compliance; and streamline our processes and procedures.

Questions and answers

Chira Barua, Sanford Bernstein

I have two questions. One is, Stuart, obviously on LatAm; when I read through your numbers, you're saying that you see an improvement in delinquency patterns, whereas actually in different asset classes, both in Mexico and Brazil, impairments have gone up either from underlying model changes or as coverage. It would be great if you can give us some details on what are the underlying movements in the two geographies and trends, going forward.

The second one is on risk-weighted assets and capital. One, is Hong Kong risk-weighted assets are up 19% in the first half; is it the beginning of a trend, or should we see this stalling at this level? And your core Tier 1 ratio, 10.1%, is this fully loaded with mitigation right now, or you have some mitigation plan on top of it? Thank you.

Stuart Gulliver: Okay. Iain will go into detail on Latin America. And then, after he's done that, I'll talk a little bit about the business in Latin America, after Iain's done the detail on the loan impairment charges.

Iain Mackay: So in loan impairment charges in Latin America, really three factors here. We'll talk about Brazil first. You'll recall that, in late 2011, we saw some deterioration in credit quality in Brazil, and principally in business banking. And, over the course of fourth quarter '11 and 2012, we took actions around the tightening of the credit standards, improving the operational management and collections capability within that business and, as a consequence of which, we do see underlying credit quality improving.

However, within the second quarter of this year, we took a look at our loan loss coverage for restructured loans, you're looking at a portfolio of about $1 billion of such accounts, and strengthened coverage in that to the tune of some $250 million, which took coverage on those restructured loans to about 66%. That's a key driver within that, and that's really the modern methodology changes that we referred to within Brazil.

So out of a total book of business in Brazil of $27 billion, we're talking about $1 billion restructured accounts portfolio with loan loss coverage now at 66%. So that was a purposeful step, on our part, to bring alignment around policy and methodology on those types of accounts. Beyond that, it's exactly as we say in the report; the underlying credit quality we see improving within the Brazilian business.

Stepping on to Mexico, specific driver here, there was a change in Government policy as it related to, shall we call it, low-cost housing, where the Government moved from what was called a horizontal strategy, so more remote, away from city centers, building larger communities of single story, second story, properties, to what they called a vertical strategy with building nearer city centers and high rises.

That had, across the construction industry, an impact on cash flows and asset values. And we recorded a provision of slightly less than $90 million for exposures to three firms in the construction business that we had in Mexico. That was the principal driver of step up in loan impairment charges in Mexico.

So taken in the round together, overall loan impairment charges in Latin America increased by some $360 million; $250 million, as I mentioned, strengthening for restructured accounts in Brazil; and then about $90 million in Mexico for the construction industry. Stuart.

Stuart Gulliver: Thanks. So going to your next question about RWAs in Hong Kong, and the jump in RWAs in Hong Kong, that's mostly actually caused by the implementation of the 45% floor loss given default on sovereign exposures. So that actually accounts for a chunk of it. If you think about it, Hong Kong's got significant deposit base, significant commercial surplus. That tends to get placed into government bonds. And once you start applying a 45% LGD on those government bonds, you can see there's a big jump in RWAs.

And, in fact, $19 billion of the jump in RWAs at Group level is caused by the introduction of a 45% LGD on sovereign bonds, which was a UK PRA initiative in the first half. And that actually explains a large chunk as to why the core Tier 1 fell back from 10.3% to 10.1%. And then in terms of does the 10.1% contain all management actions --

Iain Mackay: All management actions so far it certainly does, which is not an insignificant number, whether it's the distribution of Ping An, whether it's the running down of the US portfolio, so any number of actions included within that. Clearly, there's an ongoing effort. So when one thinks about the run-off of the US CML portfolio, which is particularly intensive from an RWA perspective, the rundown of that portfolio through the disposition of the Non Real-Estate portfolio, and now embarking on the disposition of the defaulted accounts, our ongoing management actions in that particular area.

And then if one considers also the work that Samir and his team have been doing in managing down the legacy ABS portfolios within Global Banking and Markets, again there's been a significant reduction in RWAs there, and that effort continues. So significant progress, but everything that we've taken in terms of actions up to this point is reflected in that 10.1%. But there's certainly a hopper of continuing efforts available to us which we're doing.

Stuart Gulliver: So the jump in LGD, 45% LGD, shows up in Hong Kong and in Global Banking and Markets by business line.

Iain Mackay: Yes.

Chira Barua: Thank you.

Raul Sinha, JPMorgan

Can I just have maybe one on your interest-rate sensitivity disclosure on page 172, where it looks like the sensitivity to higher interest rates has come down again, $1.2 billion now from $1.4 billion? I just wanted your comment, Stuart, on this. Should we assume that this is because you're hedging your near-term position on interest rates? Or is it also reflective of the longer term sensitivity towards interest rates for HSBC?

Stuart Gulliver: In essence, it's going to certainly turn around maturing positions as they run off in balance sheet management in the trading books. You shouldn't read anything more significant into it.

The fact of the matter is, if curves steepen, we'll make more money in balance sheet management as long as the curve -- balance sheet management will make money if the curve is steep, so either the long end tails off or the short end rallies. What I would expect under QE tapering is the long end will tail off somewhat, so that will benefit balance sheet management.

If then, in due course, QE is reversed and then interest rates start to go up as the second order impact of the US reversing the policies it put in place, then we will see a significant pickup in the net interest income of the Commercial Banking business and Retail Banking and Wealth Management as the deposit base suddenly starts to add value to it.

What you're effectively seeing in page 170 is a sensitivity of the 25 basis point per quarter, i.e., 100 basis points in a year, but doing it quarter, quarter, quarter, quarter not a step jump, would lead to about an extra $1.2 billion. That's really the CMB and RBWM numbers, because that assumes that we don't do anything with the book, which, of course, with BSM, we would be doing an awful lot with the book.

So we are not consciously reducing our ability to make money if rates go back up, not at all.

Raul Sinha: Right. And would it be fair to conclude then that this table probably understates your sensitivity to higher interest rates?

Stuart Gulliver: I think that looking at my accounting colleagues frowning at me across the table, no, absolutely not. It's what's in the table.

Raul Sinha: Okay. Message delivered. The second one, if I can just go back quickly to the Latin America provisions? Obviously, thanks for the additional disclosure you provided on the previous question, but I just wanted to get a sense of how much the rise in provision, especially on the collective side, was just you taking a more cautious view on the economic outlook in Latin America?

And then how can we read across, if at all, into Asia, given Asia seems to have little or no restructured loans at all? Does that mean that, at some point over the next few quarters, you might do the same in Asia, or is that not possible at all?

Iain Mackay: No, it's not. Raul, to my point, when you look at the increase in Latin America of $366 million, $250 million of that related specifically to increasing coverage through some updating to the model of $250 million. The underlying credit quality within the remainder of that Brazilian book is something that we've been working on for the past 18 months now and the improvement in credit quality is coming across.

You look across every other region that we've got and we've got a very stable credit picture. There's clearly markets in which there's a heightened level of scrutiny and attention and, as we manage some of the risks in it -- you wouldn't need to be a genius to figure out what some of those markets are because they tend to be in the news on a daily basis because of political unrest in some of those markets.

But the credit quality of this book has been progressively repositioned, where we've seen those risks emerge and it remains very stable.

Raul Sinha: Okay, excellent. Thanks so much.

Chintan Joshi, Nomura

Two from me, please. First one on the US runoff portfolio; I see that the loan impairment charges are quite low, meaningful lower than the trend we have seen in past quarters. What's driving this, and how should we think about what kind of impairments you need to take going into the future? Thanks.

Iain Mackay: Yes. Thanks, Chintan. I think one thing that you should note in the US is there's an effect within our loan impairment charges reflecting the uptick in the value of the collateral that underlies our portfolio to the tune of some $500 million.

If you try to get a sense of what loan impairment charges would be on a run-rate basis, I would suggest that something between the first quarter and the second quarter number's a better reflection of a run rate for the US. I would not read in the second quarter number as being the run rate, going forward. I suspect it's a little bit higher than that.

Chintan Joshi: Thanks. That's helpful. And second, if I could just follow up on the asset quality theme. Asia, as you highlighted in your outlook statements, is seeing a slowdown; there is a cycle that's currently on in Asia. What do you make of asset quality implications of that? So far, the picture's quite stable and we keep hearing about the markets in which there are problems, India, for instance. So how do you see, from your vantage point, trends, and if you do see a cycle, when can you expect to hit your book?

Stuart Gulliver: I think that over the last 2.5 years we've been quite conservative in the way we've positioned. And actually, generally speaking, we have gone for more secured exposure, less clean lending in Retail Banking and Wealth Management, CMB, self-liquidating stuff in CMB like trade finance, and also, we've been pretty cautious in Global Banking and Markets.

So I think the risk of our Indian book may be somewhat different than some of our competitors' positions in India. We've been a lot more conservative and taken a lot less risk. So actually, as we stand today, I think the entire Indian GBM book's about $6.5 billion, or thereabouts, in its entirety. So as things stand today, we're comfortable that we're conservatively positioned towards those assets.

As I say, again, as things stand today, I wouldn't say there's a particular moment in time where I see bad debts heading towards us based on the information we have today. Indeed, if there was, then we'd have been raising provisions. So there isn't, and, Iain, if you want to add?

Iain Mackay: Yes, I think if I just reflect across the regions here. You look at Europe, rest of Asia-Pacific, Middle East and North America, we've seen a reduction in loan impairment charges. We saw a very slight increase in Hong Kong and when I say very slight, I mean $14 million.

And then the rest of that story is Latin America. So again, it reflects exactly on Stuart's comments around the positioning of the portfolios over the course of the last couple of years.

Chintan Joshi: Thanks. And just one final quick one; can you update us on trade finance trends in Q2 please, volumes and margins?

Stuart Gulliver: Yes, the margins appear to have somewhat stabilized, as we said that they probably would. So we don't see a further deterioration in margin; we don't see a massive pickup either, but they've stabilized.

Chintan Joshi: And volume-wise, has the slowdown affected trade finance?

Stuart Gulliver: Yes, we've picked up quite a lot. We added $13 billion in terms of trade finance balances in the first half, so we've, I think, recaptured any market share that we might have lost.

Chintan Joshi: Good news. Thank you.

Rohith Chandra-Rajan, Barclays

Rohith Chandra-Rajan: Just wondered if I could come back to the LatAm credit quality actually, with just a couple of points of detail. I think you've been very clear on the Brazil trends. Just on Mexico, could you give some details on the size of your homebuilder exposure in total and what their coverage is, and any comments about general credit quality in Mexico?

Certainly, from some of the other banks, we've seen somewhat of a slightly wider deterioration in credit quality in Mexico in the first half; I don't know if that's the case for HSBC. Thank you.

Stuart Gulliver: Yes, the provisions are of the order of about $90 million, which is about 20% of the total exposure to builders if it all went down and there was no recovery at all.

Rohith Chandra-Rajan: Okay. Thank you. And anything else of note in Mexico, or is the rest of the book relatively stable?

Stuart Gulliver: No. No, that's it. And as Iain says, there's a Government policy change. Low-cost housing was built a long way outside of Mexico City, in particular in low-rise housing estates, which then struggled to have infrastructure actually brought out to them, transportation, sewerage, water, etc.

There's a change of Government policy where they now want to build high-rises closer into the municipal kind of -- or Mexico DF area. That's effectively resulted in a bunch of inventory that these house builders have effectively being written off with the credit impact on those companies. You'll see that, or you should see that, in all of the banks in Mexico's numbers.

Rohith Chandra-Rajan: Okay. Thank you.

Ronit Ghose, Citi

I just have two follow-up questions. First of all, on LatAm, you've given us a lot of very helpful color on the asset quality one-offs, if you like. Even if I adjust for those one-offs, with your headline return on risk-weighted assets, I think is 1% in the first half in LatAm, if I add back some

of those details Iain gave on Brazil and Mexico, I'm getting about 1.7%, 1.8% return on risk weights and I think middle of the range, if you want to be close to 3%.

I'm just wondering what are the levers you've got in the next year or two that you can discuss maybe briefly of how we get from that underlying 1.7%, 1.8% to a 3%?

The second question is one of just small detail. Thanks for your comments, Stuart, on trade finance. If I look at your PCM disclosure in GBM, there's a nice pickup half on half. In CMB, it's still going down. Is that mainly because of divestments? Is the underlying trend more stable, or is there something different going on in CMB for the PCM revenues? Thank you.

Stuart Gulliver: On the Latin American business, there are a couple of things running through it. We obviously have a loan impairment situation which we've gone into in considerable detail, number one.

Number two, we have slowing GDP in Brazil. Number three, we're also, obviously in Mexico and also in Brazil, moving forward with the implementation of global standards and, obviously, bringing things up to the highest standards in the world everywhere in the world. And that's resulting in us also increasing the investment spend that's going into those countries in compliance and risk and legal and so on.

So there will be a period where the return on risk-weighted assets in those operations will go below the 2.8% to 3.1% which is what we're generally looking for.

The levers to actually get the thing back towards the type of targets that we are looking for are nothing particularly special beyond, obviously, getting past the bad debt or the loan impairment charges that we've put in place; and secondly, continuing to manage down our costs base.

So we will go through a period, therefore, of restructuring, which essentially is what's happening, but there's an awful lot of good business that continues to be written. We set up a CMB fund in Mexico with $1 billion for international trade. We've got the first ever long-term fixed rate mortgage product out in the market in Mexico, which is for premier-type accounts, which has also had considerable take-up. And in debt capital markets, we've won Latin America's Debt House of the Year for the last couple or three years.

So it's going to take a couple or three years to get the returns to those sort of levels, but I think it's all organic work that will get us there. Part of the question is, do you go and make an acquisition? No, I don't believe we will. I believe what we will do is restructure our existing business in order to get there.

In terms of PCM, and trends in PCM, there's nothing in CMB that would suggest that there's any problem whatsoever in PCM. So off the top of my head, I can't think what the distortion of the number is, but it may be some disposals that took place during the course of the year. Because don't forget, there is a bunch of commercial banking businesses, in Latin America in particular, that we've disposed of that will have been reversed out.

Ronit Ghose: Great. Thanks, Stuart. Just going back to Latin America, just so I'm clear; you're talking about 2016, 2017, kind of 2.5%-type return on risk weighted assets as a kind of go-to number?

Stuart Gulliver: Yes. The return on risk-weighted assets in 2012 was 2.5%; second half of 2012 was 2.5%; first half of 2012 was 2.2%; and the first half of this year was 1%.

So this thing on a normalized run rate, without all of the loan impairment charges that have been running through it, was 2.2% in the first half last year; 2.5% in the second half last year; and as you rightly point out, has dropped to 1%. So we're simply, basically by removing the adjustments we've made in the first half, getting quite close to being back to the 2.2% without doing much else.

Iain Mackay: About 1.75% adjusting for the loan impairment charges.

Stuart Gulliver: Yes. And in fact, there's a bunch of de-risking going through that book, given the need to implement global standards in those countries. And obviously, we've also removed some of the fragmentation that exists in Latin America, because we've sold a whole bunch of businesses other than Mexico, Brazil and Argentina.

Ronit Ghose: But 2.5% is a steady state where you'd be comfortable with?

Stuart Gulliver: Yes.

Ronit Ghose: Or you think 2.5% is where you've been, and you can do better?

Stuart Gulliver: No, no. 2.5% is where we've been. Let's go back to 2.5% before we start worrying about whether it should be higher.

Ronit Ghose: Okay. Thank you.

Christopher Wheeler, Mediobanca

Three quick questions, if I may? The first one, Iain, you were talking about collateral values improving in the United States. Against that background, could you perhaps just update us on where we are on the sale process, or where you are, in terms of the portfolios you have available for sale, and what you think the outcome might be, at least in terms of timing?

The second question is on foreign exchange. A very good performance, clearly, given your strengths there, but I just wondered, obviously, whether you could give any indication as to how much of that performance can be attributed to the very volatile markets post May 22, and perhaps talk a little bit about the outlook?

And then the final question, I guess, is I've obviously been reading the Chairman's comments on the wires here about the EU bonus cap. And you've been very forthright in your views, which I think probably everybody on this call, and your investors, understand totally. But I just wondered whether or not you've run that past the political lobby before you actually went out and were quite so forthright? Because while, as I said, I think most people fully understand where you're coming from, I'm just interested as to whether or not we're going to have a little bit of a backlash on this from the usual sources? Thank you.

Stuart Gulliver: So we'll have Douglas answer the third question first

Douglas Flint: I don't think so. When you reflect, the UK Government voted against the proposals. The PRA have come out and said that they don't like the proposals because they would like to see the potential for higher deferral than might be implied if base salaries were to increase. And the Parliamentary Commission echoed that, and said that they believed that larger deferrals, longer deferrals, and claw-back -- to give more potential for claw-back, was the right way to go.

So I actually think the establishment, if you want to put all these three together, are in a similar place. Because the regulatory agenda has all been about increasing deferral and augmenting claw-back. And it makes it much more difficult if the consequences of the CRD IV proposals are increased in fixed compensation and on a lower deferral.

So we called it as we see it, and I think it's really important for us to be clear we are going to be going out consulting, and I think it's also very important we're clear to our own staff that we understand the contribution that they make, as do our shareholders. And we must make sure that we are competitive.

Stuart Gulliver: So on Household and portfolios still for sale, there's a note on page 263 which is sales in July which are too late for the balance sheet close, but under the events after the balance sheet day with about a $1.8 billion portfolio of -- these Real Estate, as opposed to Non-Real Estate.

Iain Mackay: So what we've got in total, as Stuart mentioned earlier on, we sold the Non-Real Estate portfolio. That closed on April 1, and there was a loss of about $270 million realized in the disposition of that, which was considerably less than when we anticipated would be when we launched that process at the end of last year. So that's now closed out.

Pat and the team are running the runoff portfolio. Now we're focused on the disposition of charged off and partially charged off first lien mortgages. And what Stuart referenced there was the first tranche, or the first bucket, of those, which total about $1.8 billion. And that'll be disposed of in two or three tranches, which is being done through a competitive bidding process, which got going in the month of July, and is going reasonably well.

Overall, we've got about $5.4 billion of such loans that Pat and the team are focused in getting out into the market between now and really the middle/end of next year in its totality. And that would leave us basically with a runoff portfolio sitting round about $25 billion, $26 billion worth of performing subprime mortgages, with a pretty healthy yield in it.

But there's a good lot of work to be done from an operational standpoint, but he's got a competitive bidding process that worked for the Non-Real Estate, but he's now running against the Real Estate, and thus far the results have been good.

Stuart Gulliver: So just then going to foreign exchange. The first quarter was $871 million, and the second quarter was $962 million. So no, there wasn't a big jump, and there isn't a one-off prop position around the June 20 events. It's pretty stable and, therefore, has a predictability to it. So $871 million, 1Q '13; $962 million Q2 '13.

Christopher Wheeler: Lovely. Thanks very much. Very helpful.

Manus Costello, Autonomous

I just had a question, please, on the supplementary disclosure you gave around your capital position. There's a paragraph in there talking about an EBA consultation on technical standards for own funds, and you talk about there being the potential to significantly increase the level of capital deduction applied as a result of that. I wondered if you could give us a bit more color about exactly what that refers to, and what sort of size of deduction we could be looking at, and whether or not it might color your views on capital distribution for next year? Does it add to the risk?

Iain Mackay: I'll let Russell answer this one.

Russell Picot, Chief Accounting Officer: So the consultation is all about capital deductions, and the EBA paper spoke to the possibility of having to look through either your lending or, indeed, to your pension fund. So if you look at the UK pension fund, there was some language around circumstances under which you might actually have to look through to the pension fund, look at the pension fund's holding of bank equities or subordinated debt, and we might have to take a capital deduction.

And a similar concept has been proposed around your lending to conglomerates. So if you lend money to a conglomerate, and that conglomerate within its group has got a banking subsidiary, so an example, I guess, would be a large company like Siemens, then you might actually have to take a deduction for the whole of your lending to that corporate.

We obviously feel this is not what they intended, and we've obviously, we've sent an appropriate letter to the EBA and the PRA. We think this is a major issue for the industry more broadly.

Manus Costello: Okay. So in other words, you think you have to disclose it, but you don't actually think it's going to be implemented as is, and, therefore, wouldn't color potential capital distribution for next year, hopefully?

Stuart Gulliver: I think that's the way we would be considering it. That's correct.

Manus Costello: Thank you.

Alistair Scarff, Merrill Lynch

Just two quick questions, if I may? Firstly, looking at your loan momentum across your various businesses. You've given us some interesting color in your disclosure there, but just anecdotally, what are you feeling from your general discussions with your top clients across regions? Is there general appetite? We're hearing lots of balance sheets, with lots of cash, but not willingness to spend. What do you think of them from a leveraging-up perspective?

And secondly, from an effective tax rate perspective, you guys slipped under 20%. Where do you think is a more normalized level of effective tax rate?

Stuart Gulliver: Taking the willingness to lend point of view, it's very hard to generalize. You could see that we did grow revenues, and we did grow lending balances, and we clearly have, with the type of AD ratio we have, and capital we have, tremendous capacity to lend to the right type of opportunities. It's very hard to generalize. We've actually found -- you saw that our Financing and ECM numbers were up 20%, first half of this year versus first half of last year.

So quite clearly, we've got material amounts of business going through and we probably still are taking market share. Our GBM numbers, I think looking at where analysts' consensus was, have surprised to the upside because, actually, we continue, I think, to prove the universal banking model works, certainly for us, and actually have taken share. But I can't really generalize and say Asia's strong and Latin America's weak, or whatever; it's very much corporate or client specific as opposed to geographic.

And tax, Iain will comment on.

Iain Mackay: I suppose we've always talked -- a normalized tax rate sits around 21%, 22%. If you reflect on the UK corporate tax rate of 23.5% prevailing at the moment, you look at 19.4%. And the main driver is impacting us being slightly lower, is the fact that the disposition of Ping An is at a much lower tax rate, largely focused on a withholding tax in China, and the fact that the gain realized on the dilution of our position in industrial banks is a non-taxable event.

So that's really what makes it up, but when you look at the distribution of our profits, our effective tax rate has just basically taken the PBT and multiplied by the corporate tax rate in each of those jurisdictions; there's nothing more mysterious than that. But then there does, from time to time, seem to be unusual or notable transactions coming through our numbers which may be treated slightly different from a tax perspective; for example, our capital gains tax that may apply at a lower rate.

Alistair Scarff: Great. Thank you Iain.

Sandy Chen, Cenkos Securities

Just two quick questions. One, just in the appendix on the quarterly basis, and I'm probably being a bit too pernickety on it, but on the rates there was a pretty big decline Q2 versus Q1. Is that just seasonal, or should we read anything more in terms of guidance on that?

Iain Mackay: LTRO, so in the first half of last year the European Central Bank banged out LTRO if you'll recall, and you saw spreads tightening rather rapidly on the back of that. And we had an exceptional quarter, exceptional half in rates' trading income in the first half of last year. If you look at the rates and go back and track it over quarters and halfs, we're pretty normal based on what we saw in the first half of this year.

Sandy Chen: Yes, okay. And then the other question. Just looking at the structure in China, in particular, I guess one of the overall concerns about China tightening, and the effect on shadow banking and the regional financials, I'm wondering if it's really a bit overegged, looking at the structure of your lending book.

And looking at the year-on-year growth, or the half-on-half growth in particular in Hong Kong, the rest of Asia Pac in, say, the trade and services, that's really quite robust. Should we expect that trend to continue because, for example, 15% year-on-year growth in the Hong Kong trade and services and 7% in rest of Asia Pac lending?

Stuart Gulliver: The honest answer is that, assuming that we remain comfortable with the risks that we're taking, yes, it should continue at the pace that business is there to be done. We've taken back market share in trade finance. If you recall, there was a squeeze in margins in the first quarter, and that margin squeeze has somewhat bottomed out.

But we've also, very deliberately, made sure that we didn't continue to find that, particularly the American banks who were coming in started to display some of our share of trade finance, an incredibly important business for us. So we very deliberately picked that up, that short-term six months self-liquidating stuff.

Whether we'll continue to see at that type of pace, hard to call, but there is opportunity and you can see it in the Hong Kong numbers. You would think that Hong Kong would be hard to get 13% year-on-year growth in PBT, but the fact of the matter is it's a very open economy and, as we continue to improve the way we run the firm, there is a capacity still to drive further profit out of there.

So somewhere between a, it's all fine and it's all coming to an end because of shadow banking, as is often the case lies the truth in these things. And I think that the second half, I doubt if we'll have as big a rate of growth in the second half, but I'd be very surprised, for example, if Hong Kong's full year 2013 wasn't above the full year 2012. It would have to go a long way into reverse in the second half for that to happen.

Sandy Chen: Right, okay. Thanks very much.

Stuart Gulliver: Time for one last one, operator.

Chris Manners, Morgan Stanley

So I have a couple of more UK-centric questions, if I could? The first one was on the Bank of England FPC PRA, they're talking about potentially asking banks to do dual reporting of standardized and modeled risk-weighted assets. And just trying to work out how that, coupled with the leverage ratio, impacts your thinking on some of the lower risk-weighted high leverage areas that you operate in such as Hong Kong mortgages?

And the second one was just on UK mortgage market. Obviously, you talk about extending at $11 billion of new lending in the UK mortgage markets, and just trying to see about your intentions there and what you think about the potential of help-to-buy scheme to support the market as well? Thanks.

Iain Mackay: So certainly, when you look at PRA thinking around leverage, I think one thing that's worth commenting is that, if you looked at us from a Basel III endpoint basis, we're sitting on a leverage ratio of 4.1, 4.2 which is probably why there's been absolutely no mention or discussion of this topic with us and the PRA, because I think they look at the overall leverage position under a fairly stressed hybrid PRA CRD IV calculation as being in pretty good shape.

When you then think about how it works across the different portfolios, and standardized versus advanced, again it's a portfolio by portfolio story. We probably look at standardized against our US mortgage portfolio and think that standardized is quite a good idea, whereas you might look at it against a particularly low risk portfolio like your Hong Kong mortgages and go, well, this probably doesn't make a great deal of sense.

I think one of the things that the regulatory community is just struggling with just now, which is something the banks can absolutely help them with, and I think we, in particular, have taken significant steps in this regard over the course of last year-end, is just much greater disclosure and understanding about what's going on in the risk-weighted asset models in terms of roll forward analysis, RWA density. And a lot of those disclosures were provided through implementing enhanced disclosure task force recommendations which came out.

And I think certainly all the UK banks have made good progress in that respect, and I suspect they'll make even more progress as we work through 2013. Unfortunately, outside the UK there hasn't been much of a drive towards broad based adoption of those recommendations.

And until we get the banking industry being, frankly, just a lot more transparent about what's going on inside the risk-weighted asset models, one can perhaps appreciate the regulators' desire to look at it on a different basis.

But I think our own view would be, banging out a standardized measure is simply banging out another measure; it doesn't really help the risk management within the banking sector. I would be a very strong advocate for the fact that an internal ratings based approach, well constructed models, stress tested, analyzed, with the right level of transparency and disclosure, gives you a much better understanding of the risk equation within a bank's balance sheet than adopting a broad based standardized approach which is not terribly risk sensitive.

The same would go for, frankly, a leverage ratio; it's a great backstop measure for the economy. You might even argue it's a good backstop measure for an individual institution, but it's not particularly risk sensitive. In fact, it's not risk sensitive at all.

Chris Manners: That's clear.

Stuart Gulliver: Regarding the UK mortgages, we are not involved in new buy schemes, or we have a very small market share because we're a direct only lender. We don't do mortgages through brokers. And actually, most new builds are actually sold through brokers or intermediaries. However, the broader second part of the help to buy scheme we will actively participate in.

So if you look at the two parts of it, the new development part, we have a market share that's actually going to be appropriate for our actual market share, if you see what I mean, which will be tiny because we don't do brokers. And in the second piece, I would expect our market share would be commensurate with our overall market share.

Iain Mackay: I think, Chris, coming back to the capital question and RWA just for a moment, if you reflect on our capital ratios, whether under Basel 2.5 or Basel III, absolutely the most important thing to note, notwithstanding some of the regulatory movement around sovereign and LDG floors, as Stuart referenced, we generated 80 basis points of profit during the half from operations of the Group, and we paid out nearly $5 billion in dividends. So 40 basis points of that 80 basis points profit.

That's probably the most important thing about the capital generative ability of this Group, and then the ability to reinvest that where the growth opportunities come through. And I think there's a good bit of chatter on the wires this morning about increasing payout ratios. I think the important thing is to look at those banks that actually do pay out very significant dividends.

Stuart Gulliver: And actually, the other comment I would make, Chris, is that, reiterating Iain's point is, you need to look at who's actually paying a dividend out; the rest of it's a bit academic. And then actually, payout ratios of around 70% suggest the business is ex-growth, because you're giving almost the entire thing back to your shareholders.

In fact, probably you are giving the entire thing back because the 30% is probably what the regulatory creep in terms of capital is demanding you retain. So in effect, if you're giving all the money back to the shareholders you're running for the dividend only, you've got no growth.

So we've seen some comments this morning saying, we've got a 40% to 60% payout ratio; Lloyds is at 70%, Lloyds, therefore, is a buy over HSBC. It depends on what is the quantum of dividends and, secondly, what's the growth opportunity because we've got lots of growth opportunities. So it could well be that our 60% payout ratio's still a much bigger actual dollar dividend amount and we've got growth.

Chris Manners: I can see that. Thanks guys.

Stuart Gulliver

Okay, that brings the call to an end. Thank you all very much.

Forward-looking statements

This conference call and subsequent discussion may contain certain forward looking statements with respect to the financial condition, results of operations and business of the Group. These forward-looking statements represent the Group's expectations or beliefs concerning future events and involve known and unknown risks and uncertainty that could cause actual results, performance or events to differ materially from those expressed or implied in such statements. Additional detailed information concerning important factors that could cause actual results to differ materially is available in the HSBC Holdings plc Annual Report and Accounts 2012. Past performance cannot be relied on as a guide to future performance.