

Transcript

Post Interim Results 2013

Meeting with Analysts hosted by Iain Mackay, Group Finance Director

8 August 2013, 9.30 am BST

Corporate participants:

Iain Mackay, Group Finance Director

Russell Picot, Group Chief Accounting Officer

Jane Leach, Head of Group Regulatory Reporting

Nick Collier, Moderator

Welcome, everybody. I will just make some housekeeping requests, please. As usual, if you could – before you ask a question – wait for the mike to arrive, and please make clear your name and institution. We will aim to finish at about 10.45, so there should be ample room for questioning. I would just like to introduce Rebecca Self, who has joined the IR team from Jane Leach's team on regulatory reporting, so I think that is a subject of particular interest to you all. There are questions that may come from Hong Kong, so there may be an interruption to this internal meeting here. We are having this meeting recorded, so there will be a transcript available some time after this meeting. Otherwise, I would like to hand up to Iain Mackay, who will be ably assisted by Russell.

Iain Mackay, Group Finance Director

Good morning. I have got nothing to say, really, so we may as well just start with questions. You have all had the chance to read through the numbers for a few days, I see quite a number of analyst reports coming out, so you have had the chance to think it through. The purpose is, really, for you to ask questions and us to do our best to respond to them for you. Why not just start with questions?

Ronit Ghose, Citi Investment Research

I forgot the instructions straight away. I was not paying any attention.

Iain Mackay

Go stand in the corner for five minutes.


Ronit Ghose

I will be on the naughty step now for the rest of the meeting. It is Ronit Ghose from Citigroup. Ian, as you have just got off the plane from Hong Kong, could you just give us some of your big-picture thoughts on Hong Kong? Loan growth was very strong in the first half. Off the top of my head, I think it was up something like 9% in the half alone. If we had met at the start of the year, you probably would have been expecting that kind of ballpark or a little bit more for the whole year. Could you just talk a little bit about what happened in the first half, and how you expect the trends to go in the second half? Did you see any cull around or liquidity tightening, particularly in mainland China, towards the end of the quarter? How are you seeing that playing out?

Iain Mackay

Hong Kong growth was driven primarily by trade, and by mortgages. That was the main driver of volume growth in the first half of the year. The margins on mortgages continue to be attractive. Now, that being said, volume year on year in Hong Kong was down from a mortgage perspective. The increase in risk weighting of mortgages, as well as a bit of a pricing uptick, had the desired effect – certainly from the HKMA's perspective – in terms of slowing some growth in the marketplace there. Certainly from our standpoint, mortgages and trade are foundational products for us, so the growth was primarily driven by that over the course of the first half.

On the trade front, also, volumes were good. There was a little bit of compression on the margin front; there was a lot of liquidity going around and a lot of competition in that space. When you reflect on the second half of the year, our economists there have quite rightly reduced the outlook for Hong Kong for the year from what I believe was 4.7% to 2.5%. I think that is a reflection of expecting things in mainland China to be somewhat less robust than the early outlook for the year was. We moved our forecast for mainland China GDP for the full year down from 8.2%, I think it was, to 7.4%. Again, from a mainland China perspective, when you think about how rapidly that economy has expanded over the last three or four years and the denominator effect, 7.2% or 7.4% is still rather robust growth when compared to, really, any other economy in the world. Slowing growth there is probably not a bad thing from our perspective, so the expectation is that things will be somewhat slower in the second half of the year. How much slower is very difficult to predict, but our economists clearly have a view, and they have basically halved the growth rate in Hong Kong for the year.



The franchise in Hong Kong is broad and deep for HSBC. The team has done a very good job on the risk-adjusted equation within Hong Kong, as well as the management of the cost base in Hong Kong. You saw an improvement in the cost efficiency ratio in Hong Kong. The grand total of loan impairment charges for the first half was, I think, about \$14 million or something like that, so it is broad and fairly deep. Although things are likely to be a little bit slower, again, I think we would expect a reasonably strong performance from Hong Kong for the full year.

Ronit Ghose

The second part of my question was about any liquidity tightness you have seen spilling over from mainland China in the second quarter, and deposit margin pressure, particularly RMB.

Iain Mackay

Certainly, from our standpoint, when you are sitting on an AD ratio in Hong Kong of 55%, you do not really run into liquidity issues. The events in mainland China in June certainly had everybody sitting at their desks and paying attention, and it certainly caused a little bit of excitement for a few days. However, in terms of any real effect on the strength of the Hong Kong and Asia-Pacific balance sheet from a liquidity perspective, others clearly experienced some stress. I think it would be an overstatement to say that HSBC did.

Chirantan Barua, Sanford C. Bernstein & Co

Ian, this is Chira from Bernstein. This is on LATAM. We are struggling with the details here, and it would be great if you could give us some colour. You gave some colour around the underlying impairments, but it would be great if you could comment on the renegotiated loans portfolio that you have in Brazil and Mexico. The past due but not impaired has dropped a lot, and you say underlying delinquency trends are actually improving. Where can we see all of that, and how comfortable are you with the current levels of coverage across the books? Thank you.

Iain Mackay

There are basically three factors impacting loan impairment charges in Latin America for the first half. The first was a portfolio of approximately \$1 billion US's worth of restructured accounts in Brazil, and the risk modelling and loan impairment accounting practice applied to that portfolio. If you will recall, at the end of 2011, we experienced some quite marked deterioration in credit quality Brazil, particularly at the lower end of business banking, the lower end of SME, as well as on the retail bank wealth management. From the fourth quarter of 2011 through, really, all of 2012, there were significant actions taken by the teams on tightening underwriting criteria, operational risk management and collection activities within Brazil. As part of that, and along with local custom, there was a degree of restructuring going on within the portfolio. The net result from a credit quality perspective is that we saw stabilisation on delinquency and overall credit migration around about the middle of last year, and then a steady state with some improvement in underlying credit quality through the second half of last year and into the first half of this year.

However, when we looked at the modelling and the accounting practice applied to restructured accounts in Brazil, it was at odds with group practice. In the first half of this year, we sent some of our experts who understood this from North America, who have done quite a lot of restructuring over the last five years, and they spent some time with the Brazilian team going through and aligning practice. As we aligned the practice, we took an incremental charge for loan impairments of \$250 million in Brazil. That took coverage on that billion-dollar portfolio of restructured loans to just over 66 %. Setting that factor aside, you actually saw an underlying decline in delinquencies and loan impairment charges in Brazil, which was a reflection of the overall stable and improving credit quality in Brazil.

We are happy with the underlying credit quality. Our appetite remains quite constrained. Principally, you see the economy slowing; the rate at which it expands is slowing. It is not contracting at this point, but the need for some structural reform within the Brazilian economy is fairly evident. The connectivity of that economy to economies such as China and other Asian economies is quite strong now, and therefore with slowing in China and the rest of Asia-Pacific, we would expect – and have seen it –trickle through to the

Brazilian economy. Although we are perfectly happy with the underlying credit quality, we felt it was necessary to strengthen the loan loss coverage for the restructured loans. That is really the entire story in Brazil. We continue to monitor it – as you would expect – very, very closely.

As for the rest of Latin America, Argentina is quite stable. In Mexico, there are really two factors coming through. One was a broader aspect, impacting the US, Mexico and one or two other countries a tiny little bit. This was that we looked at alignment of policy around the emergence period: the period at which an actual loss event occurs to the point at which that loss event becomes apparent to us, usually in the form of a missed payment, for example. We call this an emergence period, and we extended the emergence period from 10 months to 12 months during the first half of this year. For the Group as a whole, that added approximately \$200 million worth of loan impairment charges, the majority of which was in the US and Mexico.

The one other factor that impacted loan impairment charges in Latin America was a change in government policy with respect to low-cost, low-income housing. They moved from what they called a horizontal to a vertical development approach: basically, going to settlements on the outskirts of major cities in one- and two-storey properties to high rises nearer the centre of the city. The effect of that on three Corporates – builders - to which we are exposed in Mexico was that we re-evaluated the impact of that on their cash flows and the value of the land bank that they carry on their balance sheets. We factored that into the outlook for collections from those, and took an impairment charge of just under \$90 million against those three. That was in total, and that represents coverage just over 20% of the outstanding balances with those.

It is not, in our view, a fundamental question of the viability of those, but it is absolutely the case that the cash flow outlook for those enterprises has changed. When you sell a one- or two-storey house, you sell it and you get the cash for it. When you are building blocks of apartments, you have got to finish the apartment block before you start getting serious cash for those properties. We anticipate the timing and the nature of the cash flows changing, and the secondary factor is that the land banks that they had developed for the construction of properties are orientated in areas that are no longer the key focus areas for government development. That clearly is affecting the overall value. Our view is that those constructors are still very viable, but the nature and timing of their cash flows have changed.

Chirantan Barua

I just have a couple of follow ups. In Brazil, you said that your guys looked at the billion-dollar portfolio, but when I look at renegotiated loans and past due, not impaired, you are still at around about \$5 billion there. Is this already over? Have you looked at the entire book, and this is the only one that has popped out, or are you going to look at the entire book?

Iain Mackay

With respect to restructuring, we have finished the work. As it relates to the emergence period, we have still got a little bit of work to do, but the likely impact is very limited.

Chirantan Barua

Is it the same with Mexico?

Russell Picot, Group Finance

Just on Brazil, the statistic you were pulling out was the level of impaired and restructured accounts, but Latin America is not really showing much movement, is it?

Chirantan Barua

Not at the moment, but in terms of the stock.

[Crosstalk]



Russell Picot

Brazil, in dollar terms, is probably down a little bit, and down a little bit in impaired assets. As that book moves and as restructuring continues, you would expect to see some sort of flow from clean accounts into restructured. There is some work being done through the second half to embed high-level methodology changes into the detail of the impairment models.

Chirantan Barua

I totally understand that. All that I am asking is whether you have revaluated the stock that you have right now, and whether the revaluation process is done.

Russell Picot

It is. There is more detailed work, and then obviously the business conditions that will drive second half loan impairment charges.

Chirantan Barua

Thank you.

Raul Sinha, JP Morgan Securities

It is Raul Sinha from JP Morgan. Can I just follow up on the same issue? My first question is basically, 'Why do you not have the same standard across the whole group?'

Iain Mackay

We do have the same standard. That is why we are aligning Brazil to it.

Raul Sinha

But that does mean that Brazil was not at the same standard before.

Iain Mackay

It does indeed, yes.

Raul Sinha

And obviously, you started doing the work in 2011, and you have taken the charge in 2013.

Iain Mackay

No, we started doing the work as it related to restructured accounts at the beginning of 2013. We did the work around credit underwriting standards, collections and operational management through 2012, but as we started looking at restructuring account practices in Brazil, it was clear that they were not applying the same policy as the rest of the Group.

Raul Sinha

Can I just check: are there any other parts of the Group where you think you might need to do the same exercise?

Iain Mackay

Well, think about where restructuring takes place. It is principally the US, a little bit in the UK, and Brazil. So the UK, the US, and Brazil are now aligned.

Raul Sinha

The Middle East also has about \$2.2 billion of restructured loans.

Iain Mackay

Yes, large corporates.

Raul Sinha

Okay. Can I check if you can disclose the coverage ratio on the restructured book going forward, unless it is already there and I missed it?

Russell Picot

I think we did, actually. It is on Page 130. We disclose the stock of renegotiated loans, and then the individual and collective, so it is \$5.5 billion on 37.7.

Raul Sinha

So the 485 going to 687 is what you are referring to? So for the Latin America total impairment allowances on renegotiated loans, which has gone from 485 to 687, that delta is the \$250 million? Okay, thanks.

Chintan Joshi, Nomura International

Chintan Joshi, from Nomura. I have three questions; the first one is whether you can tell us how you see underlying revenue and cost growth if we back out the things that market would expect us to back out of – for example, you give a list of revenue items on page 23, but equally, like anything, there are one-off costs that are not a sustainable stream. Can we get some sense of what kind of growth rate we got in H1? I am getting 3% down on revenues for half one, versus half one last year.

Iain Mackay

So what did you take out?

Chintan Joshi

A long list of things, but most of all everything that you mentioned on page 23: gilt gains on the cost side; anything that is restructuring, which hopefully will not recur, to get some kind of sustainable run rate. There were both of those line items. We spent a lot of time digging through to get to that number, but we are still not confident whether it is the right number.

Iain Mackay

To put this in perspective, we have always got movement in non-qualifying hedges. You can back it out, but you could have the same or an opposite effect next quarter. That is highly unpredictable; it is driven almost exclusively by movements in interest rates. The net gain and completion of Ping An: by all means, back that one out. You should not expect to see that one come back again. With debit valuation adjustment, there is always going to be some impact, so again, that is difficult to predict. It is going to depend a little bit on movements in our CDS: that is a key driver in that respect, so it is very difficult to predict.

As for foreign exchange gains and sterling debt, you can absolutely back that out. We should not see that again. Reclassification of the assets held for sale by the Monaco business can be backed out, except that is an add back, and the loss and sale of HSE Bank can be backed out too. I would not back anything else out.



Russell Picot

In most quarters and most halves, you will see some sort of level of gain realised from disposals from available-for-sale portfolios. I think the item you referenced was one quarter that was perhaps unusually large, but as a business activity, that will happen.

Chintan Joshi

So how would you see it?

Iain Mackay

Excluding those items, broadly, we would see revenue being flat.

Chintan Joshi

What about in terms of costs?

Iain Mackay

For costs, we are up 2% when you take out all of the notable items.

Chintan Joshi

Our second question was around GBM in Europe. I am just making sure I have got all of the one-offs: the first one was DVA, 487; the other one was gilt, about 300. I have taken those two out.

Iain Mackay

Sorry, what was the 300 you had?

Chintan Joshi

The gilt gains.

Russell Picot

But that was last year, in the first quarter of 2012.

Iain Mackay

It was 2013, but that is just the normal churn within the BSM portfolio. If you go back to the first half of 2012, every quarter we have got some degree of gains or losses from sale of available-for-sale securities within the BSM portfolio. That is normal activity. In the first half of 2012, it was quite significant: part of the portfolio was repositioned. I would have described what you saw in the first half of 2013 as being fairly normal.

Chintan Joshi

What I am getting is that quarter on quarter GBM was flat in Europe. Is that what you see?

Iain Mackay

No. I do not think so at all.

Chintan Joshi

It feels strong; at least, from how I am seeing it. That is not what other banks are reporting, so there is definitely something missing in that picture.



Iain Mackay

Realistically, the only thing I would take out of the revenue view on Global Banking and Markets is the very strong effect in the first quarter of 2012 of the disposition of gilts. Otherwise, I see the credit business being up, half over half, quarter over quarter; the rates business being pretty much stable, again with the exception of the first quarter of last year, where we saw the benefit of LTRO and the tightening in credit spreads which was a result of that.

Foreign exchange is up half over half, quarter over quarter. Equities is pretty much flat quarter over quarter, up year over year. Securities services is pretty much flat quarter over quarter and a little bit up year over year. Asset and structured finance is up quarter over quarter and flat half on half. Financing equity capital markets is flat quarter over quarter and up half on half. Payments cash management is flat quarter over quarter and up half over half. Other transaction banking is flat quarter on quarter and flat half and half. Rates are down, for the reason I described, and balance sheet management, for reasons that are hopefully well understood.

Chintan Joshi

Was what you just read out the European picture?

Iain Mackay

That is in total.

Chintan Joshi

That is Group?

Iain Mackay

Yes. Bear in mind that for that, the vast majority sits in Europe and Hong Kong.

Chintan Joshi

But seasonality is different in Europe and Hong Kong, and I was trying to just differentiate that.

Iain Mackay

Not really.

Chintan Joshi

Okay, so that is good.

Iain Mackay

There is a strong first half, and usually a weaker second half.

Chintan Joshi

The third one was the run-off portfolio. At the Investor Day, you had said that by 2016, you hoped to get to about \$20 billion, correct me if I am wrong.

Iain Mackay

No, you are not.

Chintan Joshi

So if I then think about that \$5.7 billion that you talked about on the conference call and look at your current amortisation and write-off rates, then I get to 25 by the end of next year, which does not leave a lot of room for you. That 20 looks very conservative.

Iain Mackay

Well, no: think about what is happening here. If you think about the attrition on this portfolio for the last three years, it has been 50% in pay-down and 50% in charge-off. The 50% in charge-off is declining significantly, principally because of improving employment in this portfolio. This portfolio was not new money; it was equity refinanced money. The average tenure for people who were borrowing from us on this was about 10 years' ownership of their properties. Their repayment ability related to the employment within the household. As the economic conditions in the US improve gradually, principally unemployment and the secondary factor being property values, this has a significant effect on the overall loan impairment charges in the first half of this year.

We have seen the amount that is coming from charge-off declining significantly, and the proportion that is coming from pay-downs is increasing. However, the pay-down is the monthly payments. People are not refinancing, principally because these borrowers do not have a great deal of access to refinancing opportunities within the current US financing system. The other factor is that over two-thirds – nearly three-quarters – of this portfolio had been modified over the last four or five years, so people have fairly attractive borrowing terms based on their specific credit profiles. Neither the incentive nor the opportunity for them to refinance exists, so the main impact now in terms of slowing the rate of attrition on this is that the charge-off rate is down significantly. People are meeting their mortgage payments. The main thing that we can do here around moving this portfolio down is disposing of the partially charged-off portfolio, which is \$5.4 billion at the end of June.

Chintan Joshi

So that is the justification for the \$20 billion, because you do not model the current charge effect? Fair enough.

Iain Mackay

As charge-offs come through, we are able to dispose them. I got a note from the US overnight saying that the way in which they are marketing the \$1.8 billion tranche that they have set up, which is disclosed in the accounts, is going extremely well. They expect to complete that this year, and then they have got a remaining \$5.4 billion that they will get out over the course of next year. Then, as I have said several times, it is going to basically be a portfolio of 30-year fixed rate performing mortgages, hopefully with a fairly low loss instance against them. Delinquency dollars are down. The rate continues to decline, but principally because the denominator continues to decline with it. We are going to be sitting on a portfolio of loans that is going to sit around \$20 billion in 2016, with probably a fairly good payment rate and a reasonably good yield. Hopefully, we will see the finance company in a position of profit, with continued run-down.

Chintan Joshi

I will just add one more. In Asia, the slowdown really began in Q2. Would you say it is too early to see the asset quality impact within your book, or would you say that you should already have started seeing some impact, if there was going to be an impact?

Iain Mackay

One of the things to just reflect on, Chintan, is that what the business has been doing since 2010 has been repositioning portfolios all around the world, but not least in Asia. The business has been moving more away from clean lending to secured lending, with a strong, strong focus on the risk-adjusted picture. That is one of the factors on the revenue line: there is a strong focus on overall risk-adjusted revenues. It

is quite nice to grow revenues, but less nice when a couple of years later you give it all back in loan impairment charges. There has been a strong focus across the Group on improving the overall quality of the portfolio, and a not insignificant portion of that has been moving more to secured lending, and also focusing much more tightly on client selection.

The credit quality within the Asian portfolios, even in the latter part of the second quarter of this year, has remained very stable. We have got 22 internal ratings that we monitor for credit migration, and the degree to which you see negative migration – other than the couple of areas we have talked about – is extremely limited. That is not to say we will not see some pick-up. We are not seeing a contraction. We are seeing much slower growth, but we are not seeing a real contraction in any of these economies at this point in time. Now, admittedly, you would expect that slower growth will have some impact, but we have not seen it yet, and there is nothing within our internal ratings that is suggesting to us that you have got significant migration creep at this point in time. It is something we would expect, but we are not seeing it yet.

Chintan Joshi

Thank you.

Russell Picot

Just to add, Iain, the other way it might potentially happen is that you get an early warning. You get past due but unimpaired accounts ticking up, and Asia has not really moved since the end of the year, so that is the other metric you might see moving.

Ian Gordon, Investec Securities

Hi, it is Ian Gordon from Investec. Can I have three, all on costs, please? Firstly, I know we ask it every quarter, but on the US – now that you have given us updating timing in terms of the run-off – can you just update us on your thoughts vis-à-vis the cost step down over time? Secondly, within GBM Europe, could you just comment on the pace and scale of cost efficiency improvement? I know the H1 number had some litigation provisions in, which may have blurred the picture. Thirdly, anything to say on interest rate swaps? Obviously, you have not taken a top-up, but I would be grateful for any comments on how you see that process evolving.

Iain Mackay

I will take the third question last. That process on interest rate derivatives is going incredibly slowly, principally because none of our customers are responding to us. We are doing an outbound mailing to the 4,000-odd customers that would fall into the non-sophisticated category that have been sold anything more complicated than an interest rate cap, and the response rate is incredibly low. I would fully expect the Financial Conduct Authority to expect us to continue mailing, possibly until the end of time as we know it, until we get responses from them. The other factor that is in this is that when you do get a response, you literally have to sit down with a customer and go through what they expect, so it is by account a fairly slow process. It is going incredibly slowly. This is monitored closely by the UK business; we review where we stand on the provisioning requirement on this at least every quarter, and as we reviewed it at the end of the first half, there is simply insufficient operational data to suggest that any incremental reserve would be required.

The one area that we are still requiring guidance from the FCA on is how you deal with consequential damages. There are a few customers that are dialling in and asking for things like 'We had incremental borrowing costs; can you cover those?', which is probably quite reasonable. You have got other people dialling in and saying, 'My granny's budgie died, and I expect to be reimbursed for the purchase of a new budgerigar.' Well, no; that is not going to be covered. There is an interesting treatment of consequential damages that needs to be figured out by the FCA.

For GBM, the principal item of the legal charges was the settlement of a Madoff-related litigation with Thema. That was a new suit, based in Ireland. That was settled for \$295 million in the first half, and the investors in that fund approved that settlement on 23 July. That is good news. Beyond that, within GBM, there was a lower compensation rate accrued during the first half of the year. Other than that, what we

— saw coming through from savings was just the product of sustainable saves efforts from a systems and process perspective, and the organisational effect within Global Banking and Markets. You probably saw a couple of announcements in the last couple of weeks: Samir continues to look at the organisational structure within his team. He has now aligned his global team under three main leaders. Again, part of that is just focusing on getting the right coverage for customers; part of it is getting the right expertise aligned against the products; and there is obviously a focus on efficiency in that as well. Samir and the team have got a good pipeline around sustainable saves, and they make a not insignificant contribution to it. Beyond legal, the other main driver was a lower compensation rate accrued for Global Banking and Markets. That is a not insignificant variable for that business.

Overall, on the cost position in the US, there is a significant cost item, the majority of which is reimbursed. That is the support of the technical support agreements with Capital One, who purchased the credit card and retail services business. As those agreements come to a conclusion – which will be early next year – it will give us the opportunity to take some of the stranded costs associated with the support of those agreements, which are not reimbursed, out of the equation. Beyond that, there is certainly another \$400 million to \$500 million's worth of costs which Irene and the team are focused on. That will be realised progressively over the next two to three years. This is getting to the heavy lifting stage for the US team. They set a clear target for what they need to do to get the retail bank to profitability, and then continue building the profitability of the global bank and the commercial bank. They are doing a good job, but it is hard work in the US.

Manus Costello, Autonomous Research

Hi, it is Manus Costello from Autonomous. Can I just follow up on that US point? Maybe it is just me, but I am not entirely clear on exactly what is running through revenue and costs at the moment, and where it is coming from from that agreement, which you said drops out in early 2014.

Iain Mackay

On the second year anniversary of the dispositions – the cards and retail service business was sold in April 2011 – there are shorter TSAs with First Niagara, which acquired the upstate New York branches. You have got normal operating costs, which are the support of the technology platforms and some of the service centres. For the cards business, which is progressively being transitioned across to Capital One, there is an agreed tariff for the service that is being provided. However, as those agreements come to an end, there are support costs behind the provision of those services which are not being covered by the revenues, and we will be able to take that out.

Manus Costello

What are the numbers? I am also interested in the fees coming through in North America retail, because I am struggling to work out how much of those are related to offsetting these costs, and what the underlying level of fees should be.

Iain Mackay

I do not have the exact numbers, but approximately 85% of the costs incurred are being covered through the revenue line: through recharges back to Capital One.

Russell Picot

I think you can probably pick the numbers out from your local US filing.

Iain Mackay

10Q for HBIO will tell you the most.



Manus Costello

Okay, I will have a go. On a more general point, when do you think net interest income is going to start growing again? I am looking at Q2; it was down again on Q1. I know there are an awful lot of things in the mix, but quarter on quarter net interest income seems to tick down, and I wondered when you think stability of margin will be reached and when you think asset growth ex-disposals will start to come through.

Iain Mackay

I suppose I could be somewhat facetious and say, 'When do you think interest rates are going to go back up again?' That would certainly be a huge help.

Manus Costello

Even ex-that, I am just thinking about working through the mix shifts and working through deposit hedges, etc. There always seems to be a slight miss versus my expectation on NII each quarter.

Iain Mackay

From a NIM perspective – if you look at it from that standpoint – excluding the effect of the disposition of the cards business in the US, which was significant, net interest margin half over half declined by seven basis points. If you look at quarter over quarter, it actually improved by one basis point, so I think we have seen some degree of stability appear within net interest margin in the second quarter. If you go quarter by quarter across the main businesses, within the UK we saw net interest margin tick up a couple of basis points, second quarter over first. In Asia, it ticked up about six basis points. In North America, as you would expect, there was a step down of about 20 basis points.

In the Middle East, that took year over year down about 30 basis points and quarter over quarter down 40 basis points. The main impact on that was Egypt. We reduced our holdings of Egyptian government bonds significantly in the second quarter, for hopefully obvious reasons. Then, in Latin America, half over half actually improved, but in the second quarter we saw a step down in net interest margin. In the round for the Group there is an element of stability appearing within net interest margin, we believe. A lot of the policy rate decreases that have occurred, occurred in the second quarter, and as you are pricing your business, it is predicated based on prevailing rates.

Manus Costello

So we should expect NII and interest-earning assets to move broadly together from Q3?

Iain Mackay

I do not think that is an unreasonable expectation.

Manus Costello

Thanks.

Rohith Chandra-Rajan, Barclays Capital

Hi, it is Rohith Chandra-Rajan at Barclays. Staying on a similar comment, actually, I am just interested in your comments around trade finance, which you were pretty cautious on in the first quarter when you were seeing a fairly substantial margin decline. I think the comments earlier in the week were about stabilisation of margins, and as a result you had put on some volume in terms of trade. I am just interested in your thinking: you did not like the returns that you saw in the first quarter, and it does not look like returns have particularly improved. They have stabilised, but not improved, in the second quarter. I am interested in the thinking behind now putting on more volume. Is there more ancillary revenue to go for, or is it getting back into the market with a view to it changing in the near term?



Iain Mackay

It is not really the latter. There clearly was some compression on the pricing and margin sides, but we largely offset through volume increases, and on trade there is ancillary income – principally coming through foreign exchange – that you see from those flows of activity. If volumes were down in mainland China, the volumes held up really quite well across the rest of Asia and globally. In the round, what the commercial banking team had focused on was the trade-off between volumes and the link through from that to other revenues and pricing. As a consequence of this, they made some fine-tuning adjustments around the edges to ensure that what they were losing in margin, they were picking up in terms of volumes.

Rohith Chandra-Rajan

And that was prompted by a view that margins were stabilising, so it was more attractive now to go for the volume?

Iain Mackay

Yes

Rohith Chandra-Rajan

Thanks. And at the risk of being a bit boring, could I go back to credit quality?

Iain Mackay

Yes, by all means.

Rohith Chandra-Rajan

Regarding LATAM and your comments on Brazil credit quality improving, you gave some useful indication in terms of very recent trends in Asia. Could you do the same for Brazil?

Iain Mackay

You mean beyond the restructuring question?

Rohith Chandra-Rajan

Yes, so underlying delinquencies, etc, in the last couple of months.

Iain Mackay

It is very stable.

Rohith Chandra-Rajan

And what is your expectation for the second half, given the risks to the Brazilian economy you mentioned?

Iain Mackay

We have certainly got a slowing economy in Brazil. There is no doubt about that. I would say that the degree of tightening that we did over 2012 from a credit appetite perspective in Brazil quite marked. That being said, the data at the moment does not suggest a further deterioration; if anything, it suggests somewhat of an improvement, but looking at the underlying economics it is clearly an area that we need to keep a pretty close eye on.



Rohith Chandra-Rajan

On the Mexico home builder exposure, there was \$90 million provision, 20% coverage and \$450 million to \$500 million exposure; is that just those top three builders, or do you have more exposure to the construction sector?

Iain Mackay

That is it for that sector for us.

Rohith Chandra-Rajan

So you have no additional exposure to construction in Mexico?

Iain Mackay

Not through construction in Mexico exposed to that policy change.

Rohith Chandra-Rajan

Thank you. Lastly, for me, I wanted to ask about US credit quality. You talked about the benefits from the revaluation, which I think was \$600 million in the half. Was there some in the first quarter and some in the second?

Iain Mackay

The substantial majority occurred in Q2. .

Rohith Chandra-Rajan

Do you expect any more for the second half of the year? I know you said the charge for the second half would be somewhere between the first and the second quarter; I am just interested in your thinking behind that.

Iain Mackay

That is informed entirely by my colleagues in the US. The uptick the Case-Shiller indicated was that there is a 12% pickup in property value year over year in the US, referencing 30 June versus 30 June data. We track this across about 200 MSAs. Our portfolio did not experience the same degree of tick-up, but if you looked at the charts, as of the end of the year versus September 30, there was much more green across the 48 states in which we do lending on the chart at the end of June than there was at the end of December. That is really what informed the collateral valuation adjustment that we took in the second quarter of the year.

The team do not expect a repetition of that in the second half. It is something that is fairly difficult to predict, but there is not an expectation that we would see that tick up. What we have seen is delinquency trending down slowly; and I do mean slowly. I think it is a reasonable outlook that if the US economy continues on what looks like a slightly more robust recovery than was the case in 2009, then we would expect some gradual, continued improvement through the second half of the year. It would be gradual. When you take out the effect of that \$500 million adjustment, that is really what informs why we think the run rate for loan impairment charges for the remainder of the year is somewhere between the first and second quarter charge, as opposed to aligned to the second quarter charge, which reflected the valuation changes.

Rohith Chandra-Rajan

Are those collateral values reviewed on a quarterly basis?

Iain Mackay

When we have got property, particularly property that goes into a partial charge-off mode, we do valuations at least quarterly. If we have possession, those valuations are based on walk-through by brokers. If we do not have possession, they are basically done by market observation and drive-past, but they are done at least quarterly.

Rohith Chandra-Rajan

Thank you.

Russell Picot

Manus, just going back to your question on the servicing fee income, on page 61 of the household 10Q they say servicing fees for the personal non-credit card receivable sold was \$12 million for Q2.

Manus Costello

Just \$12 million? Okay.

Mark Phin, Keefe, Bruyette & Woods

It's Mark Phin at KBW. Just, again, a question on credit quality, for Europe this time. You reference a few individual cases, and Spain must have come through in the second quarter. There are two things, really: is that issue now done, or is there any more to come? I am just trying to get a feel of what is happening underlying that business, particularly CMB.

Iain Mackay

I think, from a Spain perspective, the extent of our exposure to Spain is extremely limited.

Mark Phin

Well, that is why I was surprised that you reference it, because that was what I had in mind.

Russell Picot

I think the Spanish is a single corporate exposure. It is not a whole series of individual exposures; it is one particular corporate. It is not that there is a whole portfolio that we are trying to catch up on provisioning. There was a single name.

Mark Phin

You probably cannot give this information, but what happens if you add up the other single name exposure? I am just trying to get a feel for what is happening underlying, apart from the provision additions that you made to those single names, which I think you referenced. Is there an underlying deterioration, or is this just a one-off?

Iain Mackay

From a commercial banking perspective, it comes through in the form of single name adjustments, basically. We obviously build a collective impairment allowance, which is based, frankly, on the development of the portfolios. As the portfolio grows, you tend to have additions for the collective impairment allowance. When you say utilisation of that, it is on single name charges: if they are significant, we obviously provide some background on it. If you take the portfolio as a whole – the

majority of which sits within the UK, when you talk about Europe – again, it is fairly stable. There is not an underlying migration down the credit quality scoring where Alan or the team come back and say, ‘Look, we have got a real concern around this.’

Russell Picot

Globally, Iain, we took the audit committee through this, did we not? There is literally a handful of single names that took hits during the first half that were of any consequence. I cannot remember the precise number – maybe it was three or four, something like that – but there was no obvious thematic connection between the names or any obvious sign of underlying weakness in sectors that was causing. It was the Mexican builders, for example, and that was a different reason from the Spanish individual exposure. There was another one in Europe, in Global Banking and Markets. Again, they were isolated and unconnected.

Iain Mackay

There was another one in Canada. So there was one in Canada, one in the United States, a couple of small ones in Europe, and then there was the Mexican building, which came through commercial banking.

Mark Phin

Okay, understood. Just in terms of the Panama disposal for the second half – I can probably get this from the local report and accounts – but can you give us some idea of the revenue and cost that is associated with that? Is it very significant?

Iain Mackay

The Panama business generates about \$200 million per year.

Russell Picot

Last year, for the full year, Panama made \$141 million in 2012.

Iain Mackay

And at the half year, it was \$53 million. So PBT impact was somewhere between \$100 million to \$150 million.

Mark Phin

That is fine. Thank you.

Vivek Raja, Oriel Securities

Hi, it is Vivek Raja from Oriel Securities. I just wanted to ask you a couple of questions about capital. The first one is that Stuart, when he was talking about Lloyds payout ratio, was talking about a 30 basis points regulatory creep. I just wanted to get your thoughts on what he would be referring to when he said that.

Iain Mackay

Jane, do you want to answer this question? Regulatory creep basically comes down to two things. There is about \$19 billion of risk-weighted assets that were added in the first half, relating to a 45% loss given default for sovereign exposures outside the European Economic Area. That affected the US dollar bloc principally, and was most noted within Asia-Pacific. That is \$19 billion, and then there was \$16 billion of incremental risk charge, which is an incremental risk charge applied to market risk and is principally a reflection of tail risk and default.

Vivek Raja

The inference is that that rate of increase continues into perpetuity?

Iain Mackay

Only to the extent that we double the exposure to sovereigns. It is a one-time hit.

Vivek Raja

Okay. I got the sense that of the 70% dividend payout and the 30 basis points of increase in regulatory add-on was a signal about how much regulatory creep there would be in the future. Obviously, we have had a couple of impacts on LGD of sovereigns.

Iain Mackay

Why do we not all leave the room and let Jane talk about this one?

Jane Leach, Group Finance

It is very difficult to tell what is coming down the tracks, really. There are some things that we have spoken about before here, new slotting criteria and the smaller things, but they are really quite small in terms of our impact overall. It is probably worth adding that we have got the CRD4 ratios, and when we look at the changes that have been announced for the finalisation of CRD4 very recently, there are ups and downs for us in those. Overall, the differences for us actually net out to very little. Now, we do not know what is going to happen as we move forward and the PRA finalise their guidance, and I am sure there are more changes to come. There is still a lot of uncertainty. In terms of what has actually happened in the half-year, we have had the changes that Iain has mentioned, but the CRD4 ones have been very little for us.

Russell Picot

It is worth mentioning that the European Banking Authority has embarked on a programme of producing in excess of 100 technical guidelines, some of which it has put out for consultation already and some of which it has not. That is going to be uncertain over the months ahead as we go through that. You will also be very familiar with the general discussions around the use of modelled RWAs; how you restore market confidence; and the use of standardised RWAs or regulatory floors that we have seen coming through in a couple of markets. We are going through a transition from an old supervisory world to a new supervisory world to a new supervisory world, and that transition is going to take some months. That is really what we were trying to signal.

Vivek Raja

My next question was really about that. When you were talking about risk weighting, I almost got the sense that the UK regulator's recent suggestion that they are going to require you to provide your risk weighting on a standardised basis was almost a knee-jerk reaction to the fact that the model-based approach is very opaque. I am just trying to understand whether there were any particular aspects within the current internal model-based approach that you think is opaque, and that the regulator would want more colour on. What would those specific aspects be?

Iain Mackay

There was an item that came out yesterday or the day before from the EBA. Did you see this, Jane? The EBA released some information about a study they had completed. I am kind of suspicious that it was the study that we completed, but interestingly, they said that the vast majority of differences they saw across IRBA were driven by differing regulatory implementations of Basel II by the various jurisdictions around Europe, and had very little to do with the bank's application of those regulations or any obvious desire on the part of banks to manage their risk-weighted asset exposures through the IRBA. I thought that was quite an interesting element for the EBA to come out and say. It is maybe not that

interesting that it is what we have been saying to them for more than a year. We have been saying, 'Look, if you look at the inconsistently with which Basel II was implemented across not just Europe but the globe, that is the material driver of differences across IRBA models.'

There are other drivers, and the European banks through the CFO network did a piece of work at the end of last year, which Andrea had asked us to take a stab at doing for them. This was just to try and dig down into the construction of IRBA models. I think we got 19 of the largest European banks to participate, and our finding was Andrea's finding, which is that it was driven principally by regulatory differences in how it was implemented across the various jurisdictions. There was another difference, which did come from how the banks within each jurisdiction had implemented the guidelines slightly differently, but that tended to be intrajurisdictional descriptions. The last element, which is completely expected, is that there are differences in risk appetite and business models. The third should exist.

The conclusions that we really drew from this – I think, in fairness, the PRA drew the same conclusions – is that if you do more disclosure and you show the flow-through risk-weighted assets, and you provide more information about the density of risk-weighted assets against your balance sheet and disclosure about how you develop, validate and test models and the assumptions that underlie them, then you are able to convey to the user of financial statements what it is that is going on inside the bank and how you manage risk, and what the overall positions of risk within the portfolio is. That is one of the reasons that drove us to do a great deal of incremental disclosure at the end of last year, in line with the 12 recommendations that came from EDTF.

Now, it is true that the PRA have asked us to evaluate what it would take to disclose risk-weighted assets under the standardised approach. We are evaluating what it would take. I think it is going to take pretty much the same as it took in terms of effort and cost to build the IRBA models, which we did in 2007 and 2008. It will take quite a bit of time, and a lot of money, and the impact on risk-weighted assets is very difficult to say. There are some obvious benefits: if we put the US portfolio on a standardised approach, I suspect we would save quite a lot in risk-weighted assets. If we put the Hong Kong or the UK portfolio on a standardised approach, it would probably cost us risk-weighted assets. You really have to do that work across something more than 300 models.

Jane Leach

It is a lot.

Iain Mackay

It is a lot of models to come up with what would be a reasonably accurate standardised-approach RWA. And what do you accomplish? You put one more set of data out there. It is just another data point, and everyone says, 'Well, it is a benchmark.' No, it is not. It is not risk-sensitive. However, I would absolutely accord with the view that banks need to do better disclosure around this. If they are going to convey an understanding of the composition of risk and the transition of that risk across periods, then they have to provide better disclosure. We did a better job of that, and in fairness, I think the big British banks in general did a better job of that at the end of the year. There is more to do.

Michael Helsby, Bank of America Merrill Lynch

Thank you. It is Michael Helsby from Bank of America Merrill Lynch. I have got a few, if that is alright. Firstly, just staying on capital, can you give us the component parts to reconcile the movement from the IFRS balance sheet to the CRD4 exposures? A lot of the other banks have given that, and it would be helpful, because yours obviously goes up quite a lot.

Iain Mackay

We provide that, do we not?

[Crosstalk]

Michael Helsby

It is on your total asset from IFRS to the total exposure number. I do not think you give it; if you have, I have just missed it. It is the net down from your derivatives and your SFTs.

Russell Picot

We gave that at the end of the year. We did 2012 in the Pillar Three document, but we have not disclosed that this time around.

Jane Leach

Do you mean for leverage ratio, or do you mean for capital?

Michael Helsby

Yes.

Jane Leach

You do mean leverage ratio. Okay.

Iain Mackay

At the end of the year, the leverage ratio is 4.2, and at the half-year it was 4.1.

Michael Helsby

Can you remind me: was the total exposure at the end of the year pretty similar to the IFRS balance sheet? I think it was. I think it was less, actually.

Jane Leach

Do you mean the supplementary disclosures, leverage ratio assets?

Michael Helsby

Yes. I just want to go from the IFRS to the CRD4 exposure. Yours goes up by 13% or so, which is quite a lot. If you look at all the other banks in Europe that have given disclosure around this, you really do stand out. I am just trying to understand why. I think it might be because you have just got a lot more undrawn loan commitments: I think you have got \$570 billion that you disclosed, but I cannot see how the credit conversion factor works for that. If you could give me that, that would be something.

Jane Leach

We can just talk through the general components of that. You take your IFRS balance sheet and then you need to gross up some of your on-balance sheet items, which we do. And then you need to essentially take out the difference between your IFRS netting of your derivatives and –

Michael Helsby

No, I appreciate how it works. I just want the number.

Jane Leach

All of those individually have an impact for us, and then we have got commitments. It is actually not really commitments; it is unconditionally cancellable facilities. You add 10% of that, and that does add a reasonable amount overall. I suppose those are about roughly equal, are they not? You have the grossing up, the difference in derivatives, and then the commitments.

Michael Helsby

Have you got the numbers there, sorry?

Iain Mackay

Yes, thank you.



Michael Helsby

Can you share?

Iain Mackay

So what are you trying to get at?

Michael Helsby

I am just saying that if I look at your CRD4 exposures and I look at your IFRS balance sheet, the movement between one and the other is very big, relative to other European banks. It looks like there is something going on at HSBC that is not going on in other banks. I am just trying to establish which of these component parts it is. Is it because you are not netting your derivatives as much as others, or is it just because you have got a lot more uncancellable commitments than others?

Russell Picot

If you take the accounting balance sheet of \$2.65 billion, the biggest single adjustment is just over \$400 billion for off-balance sheet items. Apart from various other bits and pieces that are up and down, that is the biggest single piece that gets you to that \$3 trillion number.

Jane Leach

And that is the unconditional cancellable spacing.

Michael Helsby

Thanks. I can work with that, thank you. Just flipping on to litigation, actually, I note on page 259 that you talk about all your litigation and you highlight that there may be a \$1.6 billion charge for your FHFA settlement. If I triangulate that back to the 2 September filing that they made, that is about 26%. These are the numbers that we have got to work with, so I am just asking whether that is the right thing to do. If you go back to the original filing the FHFA made, they said there was about \$6.2 billion of notional that they bought from you guys.

Iain Mackay

The way we evaluated the possible maximum exposure to this is that if the Fed won all of their points, and we lost all of our defences, that could represent a \$1.6 billion charge.

Russell Picot

I would maybe just add the word 'reasonably.' This is the reasonably possible maximum loss, and it is based on a detailed analysis.

Mark Phin

Is that just essentially your outstanding exposure, plus losses, less what is now the market value? Is that basically how that works?

Russell Picot

It is based on the assets that were purchased by Fannie May and Freddie Mac.

Iain Mackay

The ones that remain outstanding.

Russell Picot

It is based on an [inaudible] asset by asset analysis.

Mark Phin

Okay, so that is the maximum client loss. Thank you.

Russell Picot

And this is civil litigation, the detail of which you will have read, Michael.

Michael Helsby

There is another number that you reference, the \$20-odd billion number but you do not put a number on that like you have done for FHFA. Is it just because it is too hard to come up with a view? I am just trying to gauge whether that percentage of a max is applied to the \$6.3 billion or whatever it is? Is that a good guide for the rest?

Russell Picot

The disclosure will pick up individual detail of a case where it is relevant and measurable. If you look at Jaffe, for example, in the early stages I cannot remember whether we just disclosed the existence of the case. As the size of the plaintiffs' claim became clear, we disclosed that number, so that is a similar route to that which we followed here. Every case is going to be individually different, and I think it is quite perilous to read across from any one case to another. Clearly, on some of the legal cases, if you litigate and you win, you end up with a cost of zero other than legal fees. I think it is quite difficult to do much more than that at this stage. Obviously, for the US securities litigation, you can track that through the US Q's. Our disclosure obviously mirrors the subsidiary filing; they have made those filings quarterly, so you can pick up significant changes through those filings as well.

Michael Helsby

You referenced the \$300 million Madoff settlement in Ireland. Clearly, again, from reading there are a lot more Madoff claims globally. How should we think about that settlement, in terms of your recognition of guilt? Let us call it that, for want of a better word.

Iain Mackay

Every case is different. What I can say is that the Thema case represented, from our perspective, the most challenging.

Michael Helsby

Why was that?

Iain Mackay

The legal circumstances around it, and the conditions that applied to our involvement with that, represented – from an arguments perspective – the strongest arguments for the plaintiff and the weakest arguments from an HSBC standpoint. Therefore, from a legal standpoint, our team was extremely happy to get that one settled: in their view, of all the cases surrounding Madoff, that represented the most difficult.

Michael Helsby

Finally, I just wanted to go back on Rohith's point, so I 100% understand. On this half a billion of property revaluation, are you saying that there was a half a billion release from your provision? So there was \$79 million charge in Q2: are you saying that ex-that, it would have been \$579? I think that is what you are saying.

Iain Mackay

It is a change in the provision for the balance sheet, impacted by an uplift in valuation of \$500 million.

Russell Picot

I think that is a yes, then. There are two pieces to it. There is a piece which is the net change in the accounting, previously code accounting allowance, and the change in fair value of collateral which was held. So if you are trying to get run rate, as it were, that was obviously a big quarterly item.



Michael Helsby

Clearly yes.

Russell Picot

It was reflecting underlying real estate improvement in value.

Michael Helsby

So going forwards, as you mark to market the property every quarter, I am just conscious of the way that you calculate your US provisions on a rolling basis. I am just picking up on the fact that the behavioural aspect of that portfolio sounds like it has changed quite materially.

Iain Mackay

It is changing.

Michael Helsby

It is changing. I am wondering why the bad debt charge would not just be a lot lower than what you are maybe trying to signal.

Iain Mackay

It is a change in that. If you track delinquencies, two-plus delinquencies that do not relate to partially charged-off portfolios – so those that are running in foreclosure – it is a very gradual tail-off of two-plus delinquencies. There is not a step function here at all, Michael. If you track across that which is in the HBIO 10-Q, it is a very gradual tail. There is not a step function; we do not miraculously have everybody paying their bills again, but there is gradual improvement coming through the portfolio. What we have is a one-time step function, as the team went back and evaluated a marked change in the value of properties, based on broker observations of our portfolio – specifically our portfolio, obviously – between the end of the year and the first half.

Michael Helsby

Okay, cool. Thank you.

Chris Manners

Morning, Iain. Just one question, if I may. I was looking at the UK mortgage balances on page 117. I know there is an FX impact, but it looks like you have gone from \$127 billion to \$121. Even if I apply the exchange rates that you have got for the report for June and for December, that looks to be a net shrinkage of the UK mortgage book. I thought you were trying to gain share and you viewed it as attractive, and I just thought I would ask about the dynamics there.

Iain Mackay

We grew lending, but at a slower rate than in the first half of last year. When you then compared that to pay-down, it resulted in a slight decrease in net foreign exchange.

Russell Picot

If I remember correctly, Iain, did we not also sell the HFC portfolio in the first half?

Iain Mackay

Yes, but that was very small, was it not?

Russell Picot

So that probably would take you from what would otherwise be an increase into a small decrease, actually.

Chris Manners

Could I ask you to comment on how you think about that market going forward? I thought it looked like an opportunity for you guys, but you seem to have put your foot on the brakes.

Iain Mackay

A couple of things have changed, also. The impact at FLS has most definitely levelled the playing field for our competitors, which is fine: that was the intended objective, at least one of them. We view the market still as an opportunity for growth, but we have got a very conservative appetite for that risk within the UK. It is, generally speaking, low LTV. I think the average of new originations is about 57% or 58%, and the average for the book is 51%. We are not going out and doing 80% or 90% mortgages; we are doing 50% or 60% LTV mortgages. It is conservatively positioned, both in terms of valuation and with respect to debt servicing capability. Yes, it is an opportunity to grow the portfolio, but it has been grown very selectively, and the amount of lending done in the first half of 2013 versus 2012 was down significantly.

Chris Manners

Thanks. On the conference call, you had said you would participate in help-to-buy in the size of your market share. I guess that is effectively an 80% LTV mortgage.

Iain Mackay

No, we have not participated in the first phase of help-to-buy.

Chris Manners

In the mortgage guarantee piece, or –

Iain Mackay

We have not participated. Nearly everything that is being done in the first phase is through brokers. We do not do brokerage originations. Everything is direct.

Chris Manners

I thought you said that when it starts on 1 January, you were thinking of participating in a size equal to market share. No?

Iain Mackay

I do not recall saying that, but who knows.

Chris

Maybe Stuart said it. Maybe I misremembered.

Iain Mackay

Maybe Stuart said it. The facts bear out that we have not participated in the first phase. And I know what he did say this time: he said 'We are not, because it is broker-originated stuff, and we do not do that.'

Chris Manners

That is fair. Thanks.

Shailesh Raikundlia, Espírito Santo Investment Bank

Hi, Shailesh Raikundlia from Espírito Santo. I have just one question on costs, actually. You already achieved \$800 million of cost savings in the first half, compared to your target for this year for a billion. I was just wondering whether you were updating your guidance for the full year and whether it will be better than expected.



Iain Mackay

No.

Shailesh Raikundlia

Secondly, I was just wondering what the run rate would be on a quarterly basis, because underlying costs – certainly clean costs – for this quarter look to be around \$8.6 billion. You had previously guided to about \$9 billion.

Iain Mackay

Guidance on that front is not changing, either. I think what we guided to for the year in terms of sustainable saves was about \$1.4 billion. We generated about \$800 million in the first half. The guidance for the remainder of the year has not changed; the target for 2014 to 2016 has not changed; and the run rate and operating expenses on a quarterly basis have not changed.

Shailesh Raikundlia

Thanks for that. Just to follow up on Chris's question, I thought that for the second phase of the mortgage guarantee scheme in January, you were going to participate in line with your market share. That is certainly what Stuart Gulliver mentioned.

Iain Mackay

Well, sorry if we mentioned that, but that is not what we are doing.

Shailesh Raikundlia

You are not going to participate at all?

Iain Mackay

We will not participate in anything that is broker-originated. I will not say we will not participate, but our participation is going to be fairly minimal.

Chintan Joshi

The remortgaging bit could be done?

Iain Mackay

That could be done, but it does not really link up with our risk appetite, if you think about it. I am not going to say there will be no participation, but based on where our risk appetite sits for UK mortgages, it is unlikely that there will be significant participation against the second phase of buy-to-let or whatever it is called – help to buy.

Chintan Joshi

With house prices going up, would you not increase capital?

Iain Mackay

You think that is a good idea? Do you need a mortgage just now or something? Call me later, okay; we will put you in touch with the right people.

What do you think about the UK economy? Do you think UK households deleveraged appropriately? No, so you take a view on revenue growth. I would like to think that everybody has appreciated that we have got a fairly conservative risk appetite. We have repositioned lending portfolios on a global basis, more towards collateralised lending as opposed to clean lending. The client selection continues to be quite conservative. The view is from a risk-adjusted perspective as opposed to necessarily driving top-line growth, and as we have experienced in the not-too-distant past, giving it all back in the loan impairment charge line in the future. When you then look at the risk appetite, there is a recognition that you need

other operating levers within the Bank. That, to a not insignificant degree, has informed what we are doing from a cost management perspective.

Part of it is recognition that, frankly, a lot of the Bank's processes – whether customer-facing or otherwise – are not as efficient or as effective as they need to be. Some of it is recognition of the fact that, frankly, there is a bit too much bureaucracy kicking around the place, but a significant part of it is recognition that when you have got expectations with business cycles in virtually every market in which we operate – which are not synchronous; they are kicking in at different points in time – you need more than just the good old revenue line as an operating lever to work with. It has been focused around getting a better risk-adjusted profile within the income statement, and creating more operating leverage through better cost control and creating more efficient, effective processes within the Bank.

Although we have realised a lot of sustainable costs, I would argue that we have done a lot of the easier stuff. It will become progressively more difficult to do it, but the guidance that we provided in May around the sustainable saves for 2014 to 2016 is a line of sight that we feel fairly comfortable with. It comes down to some fairly grunty process re-engineering, driving greater efficiency in terms of how we interact with customers, regulators, shareholders, or you name it. There absolutely has to be greater operating leverage coming from the expense line, because with slowing economies, based on our risk appetite you are not going to drive it off the revenue line. If what we believe to be true is proven to be true in terms of getting a better risk-adjusted view, then generating 70 to 80 basis points of capital every six months, giving back 40 or so basis points of dividends every six months, and covering regulatory uncertainty is something I am pretty happy with at this stage in the business cycle.

That is an important point. I have to say, reading some of the commentary about Lloyds, I find it a little bit perplexing. Everybody gets really excited about a 70% payout ratio, but a 70% payout ratio of what? We paid \$5 billion in dividends in the first half of the year, lads. From a trader's perspective, you can say 'Hang on, what does everybody need to fund? Well, somebody has to cough up for Barclays, so we had better free up a bit of cash for that. Somebody is probably going to shell in for 38% of Lloyds; you had better free up a bit of cash for that.' However, from a capital generative perspective, this place does pretty well.

Nick Collier

At that point, let us draw proceedings to a close. Thank you everybody for coming along; thank you for your questions, and thank you Iain, Russell, and Jane for providing the answers.

Iain Mackay

Thank you very much, everybody.

Forward-looking statements

This presentation and subsequent discussion may contain certain forward looking statements with respect to the financial condition, results of operations and business of the Group. These forward-looking statements represent the Group's expectations or beliefs concerning future events and involve known and unknown risks and uncertainty that could cause actual results, performance or events to differ materially from those expressed or implied in such statements. Additional detailed information concerning important factors that could cause actual results to differ materially is available in the HSBC Holdings plc Annual Report and Accounts 2012 and Interim Report 2013. Past performance cannot be relied on as a guide to future performance.