

4Q 2019 Fixed Income Investors Conference Call – Transcript

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Prepared by: Investor Relations



Ewen Stevenson, Group Chief Financial Officer: Morning or afternoon, all. Thanks a lot for joining the call. It's Ewen here, the Group Chief Financial Officer, and I'm joined today by Iain MacKinnon, our Group Treasurer, and Greg Case, our Head of Fixed Income Investor Relations. There's a Fixed Income specific slide pack that's available on our Investor Relations website. We're not planning to talk to specific slides in our introductory comments. We'll also keep our comments pretty brief, because I'm sure that many of you will have had the chance to listen in by now to the equity investor / analyst call we did earlier today, UK time. I'll quickly run through what we've announced today then hand over to Iain for more detail on capital and funding before we open up for your questions.

Firstly, a few words on the plan that we announced earlier today, broadly three themes: firstly, exiting or running down low returning risk weighted assets and redeploying those RWAs into higher returning franchises; secondly, executing a new \$4.5 billion cost reduction programme; and thirdly, delivering a simplified organisation, including slimmed down group and central costs. We expect that this will result in a return on tangible equity of 10% to 12% by 2022, underpinned by a gross RWA reduction of at least \$100 billion, with a similar level of RWA growth over the same period and an operating expense base, in 2022, of \$31 billion or lower – that's about a 10% reduction, in real terms, from today's level – and a core tier 1 ratio of between 14% to 15%, with an intention to operate at the higher end of this range over the back end of 2021 and 2022. Many of the benefits of the plan will actually extend beyond 2022, so we would expect to see return on equity benefits to accrete over the medium term.

Turning to the fourth quarter, it was a decent set of results. Adjusted revenues were up 9%. In part, that reflected a weaker fourth quarter in 2018 but, equally, the continuing strength of our stronger performing franchises. Adjusted profits were up 29% but, on a headline basis, we had a goodwill impairment of \$7.3 billion, which meant that we reported a loss after tax of \$5 billion. As you all know, that goodwill impairment has no impact on core tier 1.

Hong Kong continued to produce resilient results in the fourth quarter. Revenues were up; adjusted profits were up 3%. But, given the growing impact of the coronavirus, we are expecting a weaker first half this year and do expect to take some incremental provisions. We're making progress on reducing our costs run rate. Costs growth was down by more than a half in 2019 from 5.6% growth in 2018 to below 3% in 2019 and, if you exclude the bank levy, second half costs were lower than the first half.

Credit costs were down 5 basis points in the quarter to 28 basis points. This included a number of items: we reduced our UK Brexit overlay by \$99 million to \$311 million; we took some incremental overlays in Hong Kong, up \$56 million to \$138 million; and we also had some incremental provisions in Argentina of \$125 million. Second half credit costs were 31 basis points so, in the second half, we were now within the 30 to 40 basis point through the cycle range that we'd previously indicated. Given the impact of the coronavirus, we are expecting a downturn in Hong Kong in the first half of this year now, and we do expect – just to repeat – that we will take additional expected credit losses into our first quarter results.

To finish on the full year 2019 financial performance before I hand over to Iain, adjusted revenues up 6%, adjusted profits up 5%, in part reflecting much better cost discipline than the previous year, with positive jaws of over 3%, and our return on tangible equity was 8.4%. With that, I'll pass over to Iain.

Iain Mackinnon, Group Treasurer: Thanks, Ewen. Let me focus on three areas: capital, funding and liquidity. Our CET1 ratio at the year-end was 14.7%, and that was up 40 basis points in Q4 and 70 basis points over 2019. This was the result of not only profit generation, but also RWA discipline. Throughout 2019, RWAs actually came down year on year by 2.5%.

On funding, the relevant focus for those of you on the call is our management of MREL, Tier 2 and AT1, so let me just cover that briefly. Holdings will continue to be the main issuer of regulatory debt. For MREL this year, we expect the focus to be on refinancing, with net issuance to be somewhere between zero and \$5 billion – more likely at the lower end of that. Gross issuance is likely to be in the low teens. We will issue primarily in USD and sterling. We don't expect to issue any Tier 2 in 2020. For AT1, looking out over 2020 and beyond, we don't expect to increase our net issuance. I know that some of you will be curious about our appetite for liability management. We will continue to reassess our issuances and, where it makes sense, we'll address liability

management. We'll continue to issue out of our operating banks where this makes sense from a funding and liquidity risk management perspective.

Let me finish by talking about liquidity risk management. We continue to focus on managing a healthy loan to deposit ratio. It was 72%, flat year on year. As a consequence, our high quality liquid assets were up and ended up at \$600 billion, reflecting that underlying A/D ratio. With that, I'll hand back to Ewen.

Ewen Stevenson: Thanks. We can now open up for any questions you have.

Lee Street, Citigroup: Good afternoon and thanks for taking my questions. Three for me, please. Firstly, obviously you made clear that the coronavirus is a post balance sheet event this morning and we've seen press talk of HSBC giving liquidity assistance to certain clients, so my question is: from the leading indicators that you follow, what can you tell us about what you're seeing on the ground in terms of credit quality in Hong Kong? That would be the first one.

Secondly, this morning you referenced ratings and that HSBC was the best rated UK bank. Obviously you're on negative outlook at S&P and Moody's, so what's your commitment to maintaining the ratings that you have presently?

Finally, just on LIBOR and unsecured securities, with coupons linked to LIBOR, is it your base case that you would deal with these by a form of consent solicitation, as we have seen in some other parts of the market? What messages and colour are you getting from the Bank of England about the timeframe for addressing those securities? Those would be my three questions. Thank you.

Ewen Stevenson: Maybe I will take the first two and Iain will take the third. Look, on the coronavirus, as you say, for accounting purposes it is a post balance sheet event, so there isn't any impact reflected into the fourth quarter financials from last year. In terms of what we're seeing on the ground, as you know, we've extended some liquidity schemes. There's been relatively modest take up. Credit quality has held up remarkably well, actually, given a combination of the protests last year and now the coronavirus so far this year. We are seeing some migration from stage 1 into stage 2, but I think we're going to have to look at forward economic guidance modelling in detail at the end of the quarter. To give you, as I said, the other extreme of an alternative downside scenario that is in our annual report, if we were go to that scenario, which really assumes the virus extending for most of this year, the additional expected credit losses would be in the order of \$600 million.

On ratings, we've always wanted to be extremely strong and sound balance sheet and capital structure. Nothing's changed on that. Today, in terms of what we've announced, it should only reinforce that, i.e. wanting to operate the bank at a 14 to 15% range and wanting to be at the higher end of that range over 2021 and 2022 as we transition through the restructuring and as we transition through Basel III reform. It's one thing for me to commit to wanting to maintain high ratings, but obviously the rating agencies need to agree with us on that view, as well.

Iain Mackinnon: On the LIBOR question, you can have a long or short answer, but what we're really saying is that we're very engaged with the Bank of England, we're very focused on the issuances that we have in place, and we're very clear about the need to address specific bonds, bond by bond, because it depends on the language in the bond. Beyond that, I don't think there's an intention that we'll end up with zombie bonds beyond 2021. We'll have to do something on a bond by bond basis. We'd have the pressure coming from the Bank of England anyway to deal with them.

Corinne Cunningham, Autonomous: Thanks very much for the call. A quick question on your CET1 ratio: your ratio and your target is high compared with international peers. Is that because an element of the capital is basically trapped, in other words it's not fungible across the Group in perhaps the same way that some other banks might be?

Then I had another question just on your tier 2 issuance plans. If I have a look at slide 11, on an end-point basis, you would be below your tier 2 minimum requirements. Is that something you expect to be running below and filling it with higher quality of capital? In other words, is the 14.7% not really 14.7% if we adjust for some shortages in tier 2 securities? Also, just what are you including in the 1.7% on the end basis? Does that exclude all legacy securities? Thank you.

Ewen Stevenson: I'll take the first question and maybe Iain or Greg can handle the second. I wouldn't say our capital is not fungible. It's certainly less fungible. If it was sitting in a single legal entity, it's obviously very fungible within the single legal entity. The moment that you impose multiple legal entities – and we have a very subsidiarised structure across the world – it takes longer to move capital from one jurisdiction to another. So there is a degree within the restructuring that we're announcing. Part of the caution on our capital ratios is the speed at which we can repatriate capital from some places back to the Group.

Iain Mackinnon: On the differential you're identifying on tier 2, it's not covered by CET1. It's more covered by the excess AT1 we carry. Greg can answer the outlook for the end-point, but what we're effectively saying is that that's our estimate at the moment.

Greg Case, Head of Fixed Income Investor Relations: Just to elaborate on that point, we are carrying a reasonable excess of AT1, over and above where we need to from a regulatory perspective. That does mitigate the need for us to run at exactly what you might call the optimum in tier 2. The end state, over time our capital stack will look more normal, but is that a three or a five or a 10 year point? That's still to be determined.

Corinne Cunningham: Just what's in the 1.7? Does that exclude all legacy securities?

Greg Case: The 1.7 on the end-point, it does. That's full CRR 2.

Robert Smalley, UBS: Thanks for doing the call. I have a couple of questions, one on coronavirus. You talked about Hong Kong; could you talk about or do you have any comments on your business over the border in China? That's one.

Two, as you pare down parts of your business globally, is there a possibility of a change in your G SIB requirement?

Three, you talked a little bit about Tier 2 and the possibility of liability management. As you look to change your business in the US, I know there are some differences in accounting on some of your longer dated Tier 2s, but do you look at the possibility of any kind of liability management there, as you change your business and these become less efficient for you? Thanks.

Ewen Stevenson: On the first two, on China, the reason for the focus on Hong Kong is just the preponderance of scale of Hong Kong for us, relative to China. Equally, you should read across the same comments I'm making about Hong Kong to having similar impacts on mainland China, at the moment. The other area that we're obviously focused on from a credit perspective, on coronavirus, is the impact it's having on supply chains globally and the readthrough into other sectors, away from China. We're still doing that work.

On G SIB requirements, we were at the very top end of the bucket last time round. The quantification is changing. I'd say, just intuitively, we haven't spent time looking at this in detail. I would think it's unlikely that there'd be any near to medium term change in our G SIB bucket as a result of what we've announced today, although it certainly takes some of the pressure away from potentially jumping up a bucket, which we were facing last year.

Iain Mackinnon: The US liability management is something that we look at, and we've done some exercises in the past. I don't think it would be right to go into the detail here.

Greg Case: Look, Rob, as always with these things, we will look at LMs where they make sense. They have to be economic. We'll go through the rationales. We've done one recently on the US bonds. I don't think what we're doing in the US necessarily changes the calculus too much. You've got to bear in mind that, over the plan – you'll see in the slides that we published this morning – the RWA base of the US is broadly stable over the course of the plan. So we're not aggressively shrinking that business.

Jacob Lauer, RBC: The first question is about MREL issuance, senior level, beyond 2020. How should we think about it? I was expecting that you guys may want to issue a bit more and pre fund some of the maturities in 2021. I appreciate you're showing that you have excess, but again, you phase into a higher requirement by 2022, so I just wanted to understand the dynamics and how that's going to play out over the next two years.

One other question I suppose is in the same context. You're shifting your capital and risk weighted assets a little bit away from Europe towards Asia, and you're also saying that you broadly match the currency exposures with your issuance. Does that essentially mean that we should expect even less euro issuance down the line? I think you alluded to most of the issuance this year will be done in dollars and sterling.

I suppose I would be repeating – finally, third question – I will be repeating a little bit what was said but, with regard to the Tier 2 securities, both longer dated and perpetual ones that do not conform to CRR 2, in your discussions with the PRA, are they sympathetic to some of these having a lower cost of funding? What are any consequences for your resolution plans of retaining the securities beyond 2021 or 2025?

Iain Mackinnon: If you go to page 13 of the deck, you'll see the maturity profile. I guess what we're doing this year is we're refinancing, which I talked about. We've got 11 that we're planning to refinance. The point you make about 2021 is the same thing. We're going to try to get ahead of that this year and refinance some of that this year. As you can see from the plan, we're fairly steady where we are at the moment. We will need to have a little bit of a tick up next year and the year after, but it's not huge.

Jacob Lauer: I was thinking that it's following off one year before for MREL, the 12 months.

Iain Mackinnon: Yes, we're trying to address that this year and it just depends on the upside for take up on that.

On the other questions, just broadly speaking, we'd say we're very comfortable with where we are and we're always in conversations with the PRA and the Bank of England, but it's early days yet.

The currency driver is really a combination of considering which currency our RWAs are in. For example, the UK businesses tend to need more sterling. Dollars is obviously an easier market and some of this just comes down to trying to balance off the RWA driver, the credit spread and the availability in the markets. We're highlighting sterling and dollars this year, but we may dip into euros, if that makes sense, as well.

Ewen Stevenson: Thank you, all, very much for getting on the call today. As per usual, if you've got follow up questions, please follow up with Greg Case through the normal Investor Relations channels, but thank you again for joining.