Post Annual Results 2011 meeting with analysts

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Nick Collier, Head of Investor Relations

What we've got is an hour and a half and it's called the Q&A because the intention is to – because there is such a vast amount of detail that goes out on the day, you don't have much time to look at it between release and the conference call, so it's a second bite of the cherry.

Flanking Iain, we have Russell Picot, who I think most of you have met, Group Chief Accounting Officer, and we've got Alexa Coates, who's Head of Group Planning and Analysis, and the team around the sides of the table are all those who have contributed hugely to getting the vast amount of information to you on the day of the announcement.

So I think what I will do is just hand it over to you as the audience to put your questions forward. I will say this: if you could wait before you ask your question for the microphone because this is being transcripted [*sic*]. So, really without further ado, could I hand over to the first questioner?

Michael Helsby, Bank of America Merrill Lynch

Thanks. It's Michael Helsby from Merrill Lynch. I think one question that never really got asked on the call that I really want to know the answer to is: what happened to second half loan growth in Hong Kong? No, I'm only kidding.

[Cross talk]

Iain Mackay, Group Finance Director

I was hoping you were asking that question.

Michael Helsby, Bank of America Merrill Lynch

No, the serious question is I just really wanted you to clarify what you are saying about your ROE delivery. Are you saying that you expect to get to the bottom end of the range in 2013, or is it the run rate at the end of 2013 that your guidance is set?

Iain Mackay, Group Finance Director

Yes, no happily. I mean from an ROE perspective we – as Stuart said, when you talk about 12% to 15% it's an interesting discussion, but we're focused on getting to the bottom end of that range in 2013. I saw it reported somewhere in the newspaper where it was 2012, which almost gave me apoplexy over breakfast, but it's 2013 that we expect to hit 12%.

Russell Picot, Group Chief Accountant

Iain could I just perhaps add one word of accounting stuff around that?

Iain Mackay, Group Finance Director

Yes.

Russell Picot, Group Chief Accountant

The one piece Michael that, just to clarify, we don't regard the own credit spread moves from the fair value of our own debt as part of that earnings measurement when we talk about the 12% to 15%, because clearly that goes up and down all over the shop and is completely out of our control, so you'd have to just remember that.

Iain Mackay, Group Finance Director

Okay, Alastair.

Alastair Ryan, UBS, UBS

Thank you, yes. Alastair Ryan from UBS. So on the management view of total operating income in Global Banking and Markets, which I think has acquired a [inaudible], just the credit rates [inaudible] obviously featured a little less at the end of last year.

Iain Mackay, Group Finance Director

Yes.

Alastair Ryan, UBS

Buried through the report are various, you know, references to legacy credit revenues, which were significant in 2010 and have gone away, and the benefit of those disappearing. I haven't really got a sense of what you think the underlying business did last year in those spaces. They've been amongst the biggest revenue swings in the group. So what you think they did on a recurrent basis last year and whether the stuff you've been doing, the core strategic imperatives that you then go on to list, whether they've increased that rate or whether the revenues are driven specifically by the size of the balance sheet you're applying to those businesses? And then secondly, whether you think you are getting an acceptable return on capital in those businesses, underlying, because clearly in the headline figures you're not.

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Iain Mackay, Group Finance Director

So if you – if we talk about legacy credit in a moment, in terms of actual revenues, the big deal around the legacy is the risk-weighted assets it consumes. In terms of the revenue impact of legacy credit on any given year, any given year is not a particular impact. What you do see coming through is an evaluation in terms of the movements in the AFS reserve, which you can see that and that tends – you know, that comes from the ABS portfolios, which largely constitute the legacy credit. So the revenue impact beyond what you see in terms of impairment and movements in valuations is fairly insignificant from the legacy trend standpoint.

Alastair Ryan, UBS

So let's – but it was $700 million dollars last year though.

Iain Mackay, Group Finance Director

Yes.

Alastair Ryan, UBS

I know you are a big company but [inaudible] that is quite a lot.

Iain Mackay, Group Finance Director

So it's about $400 million this year, right?

Alastair Ryan, UBS

$400 million.

Iain Mackay, Group Finance Director

So in terms of the underlying run rate you would expect to see coming from that in any – in a given year, what we'd expect to see is about $400 million to $500 million. Okay?

Alastair Ryan, UBS

Okay. So the business is excluding that [inaudible] –

Iain Mackay, Group Finance Director

No, when we do underlying, we exclude fair value own debt and we exclude the effect of acquisitions and dispositions and at a constant currency basis. We do not exclude the effect of things like the runoff CML portfolio in North America or the legacy credit portfolio. That is still part of the business. Now, clearly from a management – if you think about it from a management information perspective, if you – you know, Samir sits there and has information that says 'Look, this is what my legacy credit books are doing', and we manage them as a – you know, there's a team around those legacy credits and managing that book of business down. So it's not sitting there twiddling our thumbs, going 'let's hope this stuff runs off over the next six or seven years'; it is a focused effort on managing those exposures down. So in terms of – you are right. I mean, it is not peanuts in terms of the revenues by any stretch of the imagination, but the volatility around that was relatively stable over the course of 2011.

Alastair Ryan, UBS

Okay, so just to ask the question in a different way, then, the management accounts summary: how would you look at the 1.6 billion of revenue in 2011? What was the number that you would have looked at? I appreciate this [inaudible] proposing yourself in the reporting to underline, but what do you regard the revenues as having been relative to the risk-rated asset costs you were applying to those businesses. I'm just trying to get at: last year what do you think you made in the on-going business in rates and credit, because it's just a big swing in the returns of GBM delivery.

Iain Mackay, Group Finance Director

What we made in rates and credits in terms of revenues is what is reported here in 2011. That's what we made, right? And clearly that's – both the businesses, rates and credits are incredibly susceptible to movements in spreads in Europe. So when we saw the third quarter, which was awful – you saw this incredible widening of spreads, which has a direct – there's a direct correlation to revenues that we record in our credit and rates business in the widening of those spreads in that quarter. You saw spreads narrow in the fourth quarter. We saw some improvement in that, but in terms of looking at the credits and rates business we don't – you know, we're not sitting there and going, 'Well, hang on a second: you know, there's an underlying part of this business which is nice and stable and there's, you know, recurring revenues in it.' We are a primary dealer for 11 markets in Europe, and if we are going to continue in that line of business I think it's largely dictated by – at least as far as European markets go – in terms of how Europe works its way through. And, you know, you've got the can being kicked down the road again with respect to LTRO, and that's providing some stability in the current environment, but if you look beyond a two-year horizon that just creates huge refinancing risk, you know, two and a half, three years from now. But as Samir looks at his credit and rates business, he doesn't sit there and carve that out and say, 'Right, well that's – that's sort of legacy credit, that's a problem for me.' He views this as a complete business in which there are different desks traded, portfolios traded, and he manages those individually, but when it comes back to how we

review the performance of the Global Banking and Markets business, it is all in and we had credit of 335 million and rates of 1.3 billion.

Now, we've had a very strong January, including in those businesses, and you all know exactly why. So, as we saw spreads tighten again the performance within those portfolios improved significantly, but the revenues coming through those two businesses in particular – I would say not only those businesses because the level of confidence in the marketplace and the level of customer activity is clearly influenced by what they see going on in the markets. But beyond rates and credits and balance sheet management, the other businesses within Global Banking and Markets, as you can see from those revenue numbers, held up very well throughout the course of the year – very well throughout the course of the year – and generally reflects investment in those businesses: foreign exchange, where we put the e-Forex platform in; the relatively muted but nonetheless focused equities investment, particular in Asia Pacific, has resulted in a very good year for equities in Asia; the payments and cash management business is a place where we've taken market share and improved our capability, again with focused investment. So, although Samir and Stuart and the rest of us are a bit gutted about what credits and rates did in 2011, the underlying performance of the other six businesses was very encouraging. Very encouraging.

Russel Picot, Group Chief Accounting Officer

The other way, maybe, Alastair, of trying to get an answer to the question that you've posed is we've broken out on the foot of page 37 an analysis of the Group pre-tax return on risk-rated assets, trying just to bring out the relative impact of both the US consumer finance portfolio running off but also the impact just of that legacy credit line in GBM. So if you're trying to get at: 'Well, when that business goes, what did GB&M actually make in 2011,' you can actually pull out the 436 and do that metric because that's really – that's going to be – that's post – that's after allocation of costs and we have given the revenue piece of that within the GBM business performance. That's pretty much affecting the credit within GBM operating income. So that probably gives you – and obviously the rate has been impacted, as Iain has been saying, from what's been going on in the eurozone.

Raul Sinha, J.P. Morgan

Thanks. Raul Sinha, from J.P. Morgan. Maybe just one follow-up on Alastair's question and then a separate one on the US. Basically I think what we're trying to get at is what were the basis risk losses in Q3 because you had – within the European rates business you took some basis risk losses because of market movement. We kind of got that from when Samir was talking about it, so I was just wondering if you might be able to put a number on it.

Iain Mackay, Group Finance Director

Yes, I don't have the answer to that, sorry.

Raul Sinha

And then a follow up on the US actually, Q4 trends and then looking into the rest of this year: delinquencies continued to go up in Q4, obviously provisioning came down quite a long way and you have released [inaudible]. Could you maybe talk a bit about the outlook of the business and how it performed since Q3 because obviously in Q2 we had a big spike and it came down from there but, from the way we look at it, delinquencies still went up, so what are you actually seeing underlying and what is causing you to be a bit more comfortable?

Iain Mackay, Group Finance Director

No, you're right. Delinquencies did go up, albeit compared to the second quarter/third quarter movement very marginally. Delinquencies went up by some 750 million in the second to third quarter and went up by slightly less than a couple of hundred million in the third/fourth quarter movement, which was much more of a seasonal movement that we expected to see. So the third quarter movement wasn't a surprise to us and there was always – always – well, there certainly has been since I've been reviewing this portfolio, a seasonality to that portfolio where you see a rundown in delinquencies in the first quarter usually aligned to US tax refunds, where people will use that to pay their various credit cards, mortgages, other loans. That stabilises through the spring and into the summer and then you start seeing a pickup as the vacation season kicks in through the summer months and into the autumn, and it tends to continue to build, albeit at a certain – a relatively muted pace through the Christmas period, and then you see that tail off down again.

Now, what happened in the third quarter was a much higher pickup in delinquencies. We saw a pickup – now there were a number of factors as you will recall in the third quarter: there was the delinquencies. There was a catch-up element related to the cost of obtaining collateral, principally related to the extension of the foreclosure timeline as the moratorium had been in effect for most of 2011, so just extending out that timeline and the cost of paying collateral where it related to the payment of property taxes in the US on US mortgages. And the third element, which was a very slight element in terms of the increase of our provision –

it was of 148 million in the third quarter – which was the effect of some changes and refinements to the IFRS reserving model, which principally took effect of the effect of discounting in terms of the extension of mortgages and the extension of the cash-flow scenario for those mortgages. So as you discounted those cash flows back, there was a discounting effect. So those were the three principle effects that were – that caused that some 900 million, nearly a billion of increase in loan impairment charges in the third quarter. In the fourth quarter what you saw was a reasonably normalised seasonal delinquency movement but none of the other factors. We, you know, the accounting models – that bedded down. We took the effect of catching up on the impact of foreclosures and cost of obtaining collateral, and so what you saw was a normal seasonal effect within those delinquencies.

If you take a look at January's numbers, then you have seen those delinquencies continue to remain very, very stable in the month of January. What would be encouraging to see, if, in fact, we see it, is as we work through February and January and people complete their re-filings for their tax returns and get those early refunds, if we see some decline – I wouldn't expect, you know, a shock and awe effect, but if we start to see that seasonality creep through again, that would be very reassuring.

So the outlook was encouraging for the fourth quarter, because you saw aversion to something that was more akin to what we would've expected to see and clearly didn't have some of those other adjustments in the fourth quarter number. January has been encouraging but I think we will wait a couple of months before we pop open any champagne bottles. In fact, probably a couple of years actually.

Ronit Ghose, Citigroup

It's Ronit Ghose from Citigroup. Just a couple of questions to follow up. First of all, on delinquencies, could you talk a little bit around the change in the definition which you put through in the full-year accounts for how you classify delinquencies, particularly – it seems to mainly come in North America, the US. I am not aware of other UK banks that have done this. I mean there is a lot more disclosure banks are giving on foreclosure – sorry, forbearing or renegotiating a loan. Why did you add it to your delinquency number?

Iain Mackay, Group Finance Director

So it's not delinquency; it's impaired loans.

Ronit Ghose, Citigroup

Sorry, the impaired loans definition.

Iain Mackay, Group Finance Director

Yes, the definition of impaired loans. Russell, do you want to take this one?

Russel Picot, Group Chief Accounting Officer

Yes, so we have actually – as you've seen, we've actually increased the level of disclosure we have made around forbearance and renegotiated loans. So I think the first thing to say is there is a big difference between the way we have always provisioned the US consumer finance portfolio and the way we have provisioned individual accounts. So when you're looking at an individual corporate borrower, you obviously track when they miss payments, and there is a generally accepted convention that you call something impaired when you either put up a provision or they reach 90 days past due. That was the convention we also applied in the US. And on that account, an individual corporate account, there's obviously a very important relationship between the amount of the impaired loans and the amount of the specific provisions that you actually put up, so that impairment coverage ratio, the loan loss coverage ratio, has been a very important as a metric, and I'm sure you've all used that.

If you look at the US consumer finance portfolio, that is provisioned using a roll rate methodology which looks at the probability of an account starting off as a current account, then missing payments and tripping all the way through to charge off. And we calculate an overall collective accounting provision against that and its covering all the loans in that portfolio, so effectively we were providing for a proportion of loans in the current bucket, because there's a probability that those current loans would trip all the way through to charge off; we provided against loans which missed one payment, two, payments, three payments, etc. So that methodology – other than we did some refinement of how it worked in detail – hasn't changed, and the underlying 'that's how we calculate provisions' – no change. As Iain said, that was 148 for Q3.
What we then looked at was – clearly the US environment has become quite difficult with the foreclosure moratorium, etc. So we looked at – and we did months of work through 2011 on this – we looked at how accounts were behaving as we applied forbearance processes with re-aged accounts. So we tracked how accounts behave when we have actually agreed some sort of re-aging, and we effectively changed when we would – say an account which had missed some payments, we'd changed that profile of payment and we applied a much more conservative criterion for when we

then said they were not impaired. Now, in the US you've got to, I think, make a year's worth of payments before we are going to say that account, once it was regarded as impaired, could now be regarded as not impaired. And that's the definition change which has kicked up this large number in the US. We then also, not surprisingly, looked at all the other books around the world, and we also looked at all the corporate accounts. But the big tightening was in that US consumer finance portfolio, and really that definitional change about when we will regard an account as effectively being current again having once gone through this re-age or forbearance. So really it's a technical change in terms of where we draw the line on that book in terms of what we call impaired. Now, obviously one of the implications is that the coverage ratio has gone from, sort of, 70 down to 40, but frankly that's probably not a very – was never a particularly meaningful number and what you – what you would be perhaps better advised to look at is that total stock of provisions against the consumer finance book against delinquency numbers, etc, which is much more what we – when you look at the 8-K filing, that's more what we actually put out.

Russel Picot, Group Chief Accounting Officer

Sorry, there was also something – the UK banks. I guess the other UK banks don't have a subprime portfolio in the US where they have actually undertaken as much forbearance and renegotiated activity as HSBC has done.

Iain Mackay, Group Finance Director

It's a question of quantum. I mean, one of the things that the FSA has asked all British banks to do much more of this year is, one: to align disclosures; but also to provide greater disclosure around forbearance activities. If you look the UK, European banks, as Russell states, they have limited, if any real exposure to large subprime portfolios in the United States.

Ronit Ghose, Citigroup

I understand the technical change; you're saying it's technical, but obviously by putting this in impaired loans, I'm just wondering if that's something you're trying to flag about the future or is it a purely –

Russel Picot, Group Chief Accounting Officer

We regard it as being a purely technical change.

Ronit Ghose, Citigroup

Why didn't you just leave it in the footnotes or some other disclosure? Why did you put it in the impaired loan definition? We have the information.

Iain Mackay, Group Finance Director

Because it's the definition of an impaired loan. We have changed the definition of an impaired loan.

Ronit Ghose, Citigroup

I know, but I was just wondering… Okay. Maybe a separate question –

Russel Picot, Group Chief Accounting Officer

And I think they're actually audited numbers, so… There was not surprisingly quite a long and vigorous internal debate about what we should do, because effectively, you know, we also restated 2010 and we realised it was actually not – it was actually quite a significant change, and people were quite sensitive to the messaging about this, as you can imagine.

Ronit Ghose, Citigroup

Thank you. Maybe just a separate topic; I'm going back to GBM. We talked about rates and credits having a bad year. On the flip side, foreign exchange had an amazingly good year. I can't think of another big bank that's reported foreign exchange revenues up over 20% year on year. I just wondered if you could talk a little bit around that, and give us any granularity regionally, in terms of [inaudible] that the other big banks don't have such a big Asian business. Is there any kind of regional split you can give for where that 20% has come from [inaudible] the London business, the Singapore, Hong Kong trading rooms?

Iain Mackay, Group Finance Director

You look at the Forex line, Hong Kong and the rest of Asia Pacific had a very strong year in Forex. Europe had a strong year in foreign exchange. Latin America had a strong year in foreign exchange. I think the only region that did not have a particularly strong year was North America foreign exchange. Part of this – so one of the things that we did draw people's attention to was the improved collaboration between CMB and Global Banking and Markets in terms of cross-sell of Global Banking and Markets products into commercial banking, where we generated half a billion of incremental revenues this year. A not an insignificant portion of that was driven by Forex, which, as you would expect on the back of essentially supporting trade flows, foreign exchange is a not insignificant opportunity in that regard.

So, across the piece, as we've invested in some of the foreign exchange platform enhancements within the business and then got the linkage with the Commercial Banking team flowing more effectively, those are two key factors and then frankly just the levels of activity that we saw in Asia, where you saw very robust

performance in the rest of Asia Pacific and – and, you know, a reasonably good year for most of the year in Hong Kong.

Chintan Joshi, Nomura

Hi, Chintan Joshi from Nomura. One of the topics we discussed on the call was your cost income target ratio and you said that we'll probably need to revisit that to make it absolute. If I look at consensus numbers, here I can get about 56% out in '13. So not necessarily pricing in the range that you have guided to. I guess what I'm asking here is that commitment to operating levels – is that still there, because that is what we do take seriously and just want to have that clarified?

Iain Mackay, Group Finance Director

No, it's a good question. Absolutely. I think one of the things that we'll consider when we get to our investor strategy update in May is possibly putting a cost number as opposed to a ratio as partners up with the cost number. I'm obviously not going to give you the number, but as we put our plan together for 2012 and 2013 and 2014, we are very focused on a number as well as the ratio and are driving the businesses to deliver efficiency that delivers sustainable cost savings to achieve that number. So I think we've always used a ratio, because I think it is important to demonstrate, as you say, that operating leverage. However, I think Stuart's comment is angled at the fact that certain of the markets, particularly Europe, don't necessarily present a particularly stable operating environment for the period of time where we are focused on accomplishing a fairly significant re-engineering of the business. But the commitment to operating leverage is absolute.

Chintan Joshi, Nomura

Thinking about a number and revenue trends could have sensitivity, so your cost number would have similar sensitivity points?

Iain Mackay, Group Finance Director

Well, so – I will give a little bit of bias from my 12 years at GE. If revenues go down, I have a preference to see costs go down with them. So one of the targets – one of the elements that we've got in terms of measurement for our CEOs around the world is positive jaws. So, as we see each month's results, we'll go through each region and we'll go through each global business, and if we don't see positive jaws coming through the numbers we'll pick up the telephone and have a little chat about what – about what the teams are doing.

Chintan Joshi, Nomura

Just continuing on costs, if I look at your Asian businesses, costs are growing by about 10% across Hong Kong and Asia Pacific, and you're trying to create efficiency generally – have a cost plan. If I look at your peer Standard Chartered, they probably are growing at about 7%, so I'm just trying to see where the differences are, what is it that is driving the differential in costs that you see versus what you [inaudible].

Iain Mackay, Group Finance Director

So I think our cost-efficiency ratio in Hong Kong is about 47% and Standard Chartered's is about 55% or 56%, I think it is. So in terms of operating – and we've got positive jaws, and in terms of operating leverage in Hong Kong, I think, you know, the team does a good job there. They have got more to do; they recognise they've got more to do. Clearly in terms of scale, we're about twice the size of – in fact, slightly more than twice the size of Standard Chartered in Hong Kong and have a much broader business offering as well. Their business there is really wholesale. It's three-quarters wholesale, a quarter retail, whereas we've got a very clear balance, where we're, you know, probably about 40% retail and – and the remainder of the piece of the pie split between wholesale and commercial banking. So there is a very robust balance to the business within our Hong Kong franchise.

Clearly what we saw was very robust growth in the first half of last year, some of it driven by technicals in terms of cross-border renminbi/dollar trade, which was deliberately slowed down by the regulators in the second half of the year for particular reasons, and that was most notable in the Hang Seng results for us. But in terms of how we've grown that book over the course of the last two or three years, the commercial banking business has almost doubled in the last – last two to three years, and the overall scale of the Hong Kong business in terms of loans and advances to customers has almost doubled over the last three or four years. So that is not at all indicative of the fact that Hong Kong is going ex-growth but what it is indicative of in terms of our behaviour was that we recognised what we believed was a need to slow growth somewhat in the second half of last year. That doesn't mean we go ex-growth, but it does mean that we delayed – we tightened risk appetite over the second half of the year.

Chintan Joshi, Nomura

If I could have one last question focused to Latam, their volume growth was -5 in the second half. I'm just wondering what happened there, and could you split [inaudible]?

Iain Mackay, Group Finance Director

So, broadly in Latin America in the second half we did a fair bit of tightening around our consumer portfolios. We did see some – and we talked about this in the report – we saw some pick up in loan impairment charges in the second half of the year, and really ahead of that we saw the need to do a little bit of tightening. In fact that's been going on for some time. There's a bit of tightening around retail bank credit quality in the second half of the year. There are also a number of businesses around the world where currency movements were a significant impact first half/second half: India, Brazil, and Mexico were all significant elements. So if you strip it out and do it in a constant currency basis, it's a much more balanced view first half to second half.

Jason Napier, Deutsche Bank

Thank you. Jason Napier from Deutsche. Three quick ones, if possible. Just coming back to the question of the definition of impaired and so on. In encouraging us to look at, sort of, provisions to the total loan book, it's about 7 billion across the book on the bad debt charge last year was [inaudible], so about 5% of loans and in saying that you, sort of, used the roll methodology. What proportion of provisions in aggregate would you say relate to the current book, because I imagine that that's got to be tiny? That can't be the reason why we should look at aggregate provision.

Iain Mackay, Group Finance Director

In terms of currents or things that would be concerned – zero to – zero to… actually current is current, so zero to 10 days, in effect. The degree of provision within the roll rate methodology that applies to the consumer finance portfolio that sits in the current bucket is virtually nothing.

Jason Napier, Deutsche Bank

So the roll methodology which – my understanding was that was why Russell was saying we should look at provisions to the aggregate book.

Russel Picot, Group Chief Accounting Officer

That's what you end up with as a – that's one metric. We also look at forward coverage ratio.

Iain Mackay, Group Finance Director

And we also look at coverage – so when you build this, when you look at the model for the team in the US and we look at reserves and provisions on a monthly basis, we're looking at each age bucket so we're looking at current, zero to 30, 30 to 60, 60 to 90, 120 all the way through to charge off, which is now 180, and the level of provision builds based on performance characteristics. So as you can imagine, by the time you're getting into the 90 days, 120 days, you're picking up a much more significant proportion of coverage the further through the roll rate process that a loan progresses.

Jason Napier, Deutsche Bank

Okay, so the guidance in a sense you're, sort of, giving is that provisions of about one year's bad debt charges, unchanged by the coverage ratio that's published, and you're happy with the recidivism and adequacy of the book, that's all?

Russel Picot, Group Chief Accounting Officer

There is a table on page 130, Jason, that you might just want to take a look at in detail. It takes the Group's renegotiated loans and then breaks them out into effectively current, past due but not impaired and impaired, and obviously the residential mortgage line has been heavily driven by the US. It's a new disclosure we've made which just gives another way of looking at the quality of those portfolios.

Jason Napier, Deutsche Bank

Secondly, just to be clear, the nearly $1 billion of catch-up provision in the third quarter, the language in the Q seemed to suggest that most of that was around TDR treatment rather than collateral. Did I misread that?

Iain Mackay, Group Finance Director

So there is a difference between US Gaap and IFRS. So if you read the Qs they are based on US Gaap. Our reports are presented on an IFRS basis. What TDRs did was in effect take anything that was classified as a troubled debt loan and do a lifetime loss expect – a lifetime loss reserve for troubled debt, whereas what you do under IFRS is an incurred loss experience, which, as you work through the roll rate model, that experience of incurred loss builds as – as you go through later stages of delinquency, whereas anything that was classified as TDR, and you've got tonnes of detail on that and the 10 Q for the finance company, under US Gaap goes to a lifetime provision.

Jason Napier, Deutsche Bank

Okay. But –

Iain Mackay, Group Finance Director

Lifetime loss rather.

Jason Napier, Deutsche Bank

You're talking at a Group level of about 900 million of increased third quarter bad debt charges. It's not to do with anything on the TDR side?

Iain Mackay, Group Finance Director

It's not to do with TDRs.

Jason Napier, Deutsche Bank

And only roughly 15% of that, you're saying, is due to the accounting policy shift.

[Cross talk]

Russel Picot, Group Chief Accounting Officer

Yes, we've built about 700 – if you look at just the stock of the provisions, we've built about 700 incremental provisions during Q3 of the US block.

Jason Napier, Deutsche Bank

And then last one, and forgive me if I've missed it in the disclosures, could you give us some sort of colour around the rough P&L breakdown of the card business? We've got PBT, we've got the PAT. Is there an NII disclosure?

Russel Picot, Group Chief Accounting Officer

Yes. In North America there is.

Jason Napier, Deutsche Bank

Okay. I'll find it.

Iain Mackay, Group Finance Director

So there's a breakdown in the North American section at the front.

Russel Picot, Group Chief Accounting Officer

On page 88 we split out the cards book, so run-off portfolio and then the balance of the retail business.

Mark Phin, Keefe, Bruyette & Woods Limited

A follow up first of all just on the operating leverage: is that excluding cards business or is that all in – that we should look for a decline in the cost-income ratio for next year?

Iain Mackay, Group Finance Director

So, all in we should look for a decline from this year to next year. There is, however, a point that I would leverage – it's not necessarily an operating leverage, and that is that the cost-to-income ratio of our cards business in the US is about 33%. The Bank generally runs – depending on which business and which country you look at, you're running at a cost-income ratio, and cards is probably one of the lowest, if not the lowest, in the Firm. It's an incredibly efficient platform. So the disposition of that halfway through the year will clearly take out – probably not quite half a year's cost, because we've got transition agreements where we'll support the transition of these portfolios across to Capital One over quite an extended period, but there will, nonetheless be a very significant component of operating cost that will come out as a result of the disposition, but we clearly view the overall operating efficiency of the Group for everything that's in the Group, so the focus will be on driving down the cost position overall and the cost-efficiency ratio. One of the headwinds we are dealing with in the ratio is the disposition of the cards business, but it's all in.

Mark Phin, Keefe, Bruyette & Woods Limited

Okay. Thank you. And then just thinking – well, on the – I know individually they're small, but if you ex out the US businesses that you're selling, can you give us some idea of the aggregate income and cost that are coming out of the business via the disposals?

Iain Mackay, Group Finance Director

So that's one of – it is not the reason, but the disclosures that Russell just referred to on page 88, will help you go through in reasonable detail that at least disposing of the cards business will give you a sense of what that does. Disposing of all the 185 branches of upstate New York, what I can say is that the cost-efficiency ratio of that particular branch network is very high, so disposing of those will actually be a little bit of a tailwind for us in terms of the actual cost position of the United States. If you think of the network for the US as a whole, it is slightly over 400 branches, with the remainder of those branches being situated in major metropolitan areas, like the tri-state area in New York, particularly San Francisco, Los Angeles, San Diego, Chicago, Washington DC. So we have focused on the major metropolitan areas from a premier offering perspective in the US.

Mark Phin, Keefe, Bruyette & Woods Limited

And ex the US – ex the cards business and the branch business, I am just trying to get a feel for all those other however many, 14 or something that you've –

Iain Mackay, Group Finance Director

Oh right, so the rest of the world outside the US?

Mark Phin, Keefe, Bruyette & Woods Limited

The rest of the world: just at sort of an aggregate sort of level, and also whether any of the cost savings that are coming out because of those disposals have found their way into the 1.3 billion in annual cost savings.

[Cross talk]

Iain Mackay, Group Finance Director

No. So our sustainable cost saving is excluding disposition – that is operating efficiencies driven within the firm. So if you think of the four buckets that we laid out at the strategy day around simplifying head offices and redesigning and re-engineering global functions, consistent business models, IT – it falls into those four buckets and it is not dispositions. If you look at the other deals that we have announced, the majority are in the Retail Banking and Wealth Management space. They are all in businesses that were breakeven or neither much worse nor much better. They were all in areas where the cost efficiency ratio was high. They were all in separate areas where liquidity provided to the Group was either negligible or not relevant to the businesses we keep in those countries.

So there are a couple of – as we've gone through the five filters analysis throughout the course of this year and continue to do it, we have looked at one or two retail business which in and of themselves are basically breakeven businesses in that country, but when you looked at the liquidity they provided to support the commercial banking business in that country and the importance of that country strategically to commercial banking, we said 'Right. Let's keep that business and make it breakeven. As long as we can keep it in breakeven or better that's fine,' but the deposit base, the stable deposit base that that provides to support Commercial Banking development, is really important.

An example of that is Bangladesh, for example. So you sit there and go, 'Well, how important is Bangladesh?' Well, actually there's a huge movement of the rag trade in Hong Kong to Bangladesh, so there is a really important trade flow between Hong Kong, mainland China, other parts of Asia, with Bangladesh, principally because of the rag trade, and our customers across the region view that as important from a Commercial Banking standpoint. So we will probably maintain that retail banking – it's a tiny retail banking presence, 13 branches, but it's an important liquidity provider.

Mark Phin, Keefe, Bruyette & Woods Limited

Thank you.

Russel Picot, Group Chief Accounting Officer

Iain could I just maybe just add a point of detail on that reply? If you take a look at the regions and we break down the regions by country, by business, if look at the infamous 'Other' line, in say Latin America that's our Latin American businesses, excluding Argentina, Brazil, Mexico, Panama, and you look at Retail Banking and Wealth Management, we lost $55 million. So that's, as Iain was saying, part of the driver – main driver is we are attacking the losses from sub-scale business. So the Central American disposal will clearly attack that loss that we suffered, that drain. That gives you a sense of what we're actually doing in terms of numbers.

Mark Phin, Keefe, Bruyette & Woods Limited

Thank you.

James Chappell, Berenberg Bank

Just sort of, I suppose, continuing on the US theme, I wanted to try and get an understanding and maybe a bit more detail on what the run rate of the cost base actually will be in the US, because I've seen the disclosures and you've given, what, sort of 4.3 billion as the cost number between the runoff and the rest of the Retail Bank. How is that being affected, particularly, say, like the Real Estate Owned Portfolio? I would imagine that's got quite significant costs attached to it, and you have not been able to go to foreclosure. In terms of what you've done, how much that kind of impact has had on that base and as those businesses run off? Apologies if you have talked about this before, but how we should think about that cost base going forward? Is it just going to be flat because you've got to hold that cost base to run the businesses off, or how quickly you can run down that retail business, because the costs incurred look very high?

Iain Mackay, Group Finance Director

When I feel in my more sympathetic moods, the direction to which I sent most of my sympathy is to Irene Dorner in the United States, because she probably has the most difficult job in the Group on any number of dimensions, but the cost channels that Irene and the team have post the cards and the branch disposition to get that cost efficiency ratio into a sustainable level is a significant piece of undertaking. Now, interestingly the most significant part of that challenge is in the US bank. So the focus on reengineering of technology, the go-to-customer front end of the business and the support functions is a major area of effort by Irene and Eli and the rest of the team in the US. So again, if you look at the cards business very efficiently, if you actually look at CML, the cost efficiency ratio of those revenues are coming off, and you're right, there are increased costs in

the REO portfolio because these portfolios are staying a little bit longer, not much longer, but about 30 days longer in real estate owned than was the case a year ago or two years ago. But also the costs of maintaining that property before it goes into REO has gone up not insignificantly over the course of the last year. However, we are back doing foreclosures and as the tempo – although it is a slower tempo than it was because we continue to be under very close supervision around the quality of that administrative process – the tempo of foreclosure is slower, but as that tempo picks up I think we all expect to see the duration of the REO on balance sheet probably revert to where it was, sort of around 160, 170 days and the costs come back into line. So that, in and of itself, is not something that we're particularly concerned about in the longer term, but the focus for Irene over the course of the next couple of years is particularly on getting the cost efficiency ratio for the US bank very much back into something that is more – I don't think you'll ever see it down in the 48 to 52, more specifically the US bank alone, but it clearly needs to come down a great deal from where it is at the moment, in the high sixties and seventies.

James Chappell, Berenberg Bank

Could I ask you – I mean I'll come back to – the high sixties? Is that what you are saying is normal?

Iain Mackay, Group Finance Director

No, well I think Irene's got a number. It's in the low sixties, high fifties, but that… we're talking two/three years out for that.

James Chappell, Berenberg Bank

Thank you.

Michael Helsby, Bank of America Merrill Lynch

It's Michael Helsby again from Merrill Lynch. The costs in the fourth quarter, I think you asked on the conference call, were higher than the third quarter excluding notable items. I think you said that there was some sort of regulatory cost in that. Can you just give us a little bit more colour? Is that like a one-off regulatory or… these things tend to be quite sticky, so give us a bit … I've got a couple of other questions.

Iain Mackay, Group Finance Director

That increase of some 200, it was made up of… We dug into it in great detail over the course of late December, early January, it was made up of lots of small items. Probably the two most significant items was higher compliance and regulatory costs, principally in the Unites States, principally related to addressing consent cease and desist orders that we'd got in place with respect to foreclosures, and I suspect the Bank Secrecy Act and anti-money laundering activities, so that we have a very significant number of people in the US doing remediation activities. There is a massive number of consultancy help being provided by various government agencies for which you have to shell out and pay. And they are higher costs, but as we work through the cease and desist consent decrees, we would expect to see a significant proportion of the remediation cost. There will be a sustainably higher level of compliance cost not only in the US but around the world, because the standard as it relates to anti money laundering, for example – know your customer in every regard – has gone up very, very significantly, even when we apply what we think are very stringent standards within HSBC. So overall that is the headwind that we are dealing with across the group, but notably the remediation costs in the US are likely to be elevated for the next couple of years.

Michael Helsby, Bank of America Merrill Lynch

So that 9.7 is the base that you are kind of taking into 2012 ex disposition notes?

Iain Mackay, Group Finance Director

Looking at January we were a little bit lower than that, but you are in the right ballpark Michael, yes.

Michael Helsby, Bank of America Merrill Lynch

Just on the GBM point, clearly the rates businesses and credit are impacted; were there any material changes in the inventory levels that that business carried over from the start of the third quarter to the end? A lot of the European investment banks cut back quite aggressively on inventories and therefore wouldn't necessarily have saw the same balance of what they lost, if you like, over that period.

Iain Mackay, Group Finance Director

Inventories of…?

Michael Helsby, Bank of America Merrill Lynch

In credit and rates. You know, you've referred to your market-making operation. Clearly you've…

Iain Mackay, Group Finance Director

No, well I mean, across… If you go into the European disclosures that we've got on, I think, either page 114 or 115, in terms of our exposure to the sovereigns and the

agencies, the banks and other financial institutions, we reduced them significantly across the course of the year. We continued to play a very significant role both in Italy and Spain, so you will see slightly higher exposures in those countries, because we are a primary dealer in those countries and will continue to play, you know, a responsible role in those areas. But you saw trading assets come down significantly in the fourth quarter from the third quarter and that was a concerted effort by the desks to get their numbers down. Now, you do tend to see that year over year, but there was nonetheless a very concerted effort in the second half of the year to manage down some of the trading desk positions. So yes, I mean, we've managed our inventories down.

Michael Helsby, Bank of America Merrill Lynch

On US cards, can you give us an update on when you think that's going to complete?

Iain Mackay, Group Finance Director

Second quarter, we're still waiting for regulatory approval, but there are some signs of encouragement in that regard. You probably saw that Cap One had got approval for their ING acquisition; they bought the ING online deposit business, which gave them access to some 40 billion deposits. That was approved, notwithstanding some objections from Barney Frank's committee with respect to Community Reinvestment Act credits, so that was encouraging. But there's no contingent link between that and our transaction, but it's moving along reasonably well, so sometime during the second quarter, and really what it's subject to now is just the regulatory approval.

Michael Helsby, Bank of America Merrill Lynch

Thanks and just finally I noticed on page 331 you pulled out a 4.9 billion potential tax loss in the UK, so I was wondering if you could give us a little bit more colour on that and also just a bit more of an update on the over 5 billion of DTAs that you've got in the US. Should we think of the US gain that you make on cards coming straight off that balance?

Iain Mackay, Group Finance Director

So the UK CFC is a long-standing debate between HMRC and ourselves, and it relates principally to our Asian operating entities. They are and have been for a very, very, very long time held by Dutch holding companies. The dividends from those companies flow to their parent, which is in the Netherlands, and it is then those dividends that are ultimately remitted to the UK to support part of the dividend to the principal shareholders of the Group. The UK has asserted that their CFC law gives them the right to tax those profits and we have asserted absolutely the opposite and have a very robust legal counsel opinion to that effect, in fact several legal counsel opinions to that effect. The case law in the European Court of Justice is very much in support of our position on this, but this matter has been out there now for quite some time and we continue to work through it with HMRC. As you can imagine HMRC is very much under the microscope at the moment in this regard and we expect this to take a little bit longer to sort it.

On the DTAs in North America, sorry, you know our expectation around the utilisation of those DTAs is really over the next three to four years. We absolutely test them continuously from an impairment perspective, but in terms of – they are part of a US consolidated tax group in the US, so it's not tied specifically to the profitability of the finance company or the banks. So, the profitability of the bank, which we would expect overall to see our North American operations return to profitability within in the next couple of years; that certainly is well within the lifetime of these deferred tax assets, so we would expect to utilise them over the course of the next few years.

Michael Helsby, Bank of America Merrill Lynch

Does the card gain just get knocked straight off it or does it not work like that?

Iain Mackay, Group Finance Director

No, they are – so the treatment of capital gains are slightly different in – as related to deferred tax assets within the UK, so it relates primarily to net operating loss carried forward and I can check into that and come back, but I don't think the capital gain falls directly into that.

Russel Picot, Group Chief Accounting Officer

I think, Iain, what we are expecting is that there will be a slight acceleration and utilisation of the loss carried forward and the tax credits, so, as Iain was saying, over a three or four year period, but then there is the remaining piece, which is just derived from the normal US situation, where you don't get tax relief until you actually charge off accounts. So that's got a longer life, because that element of the DTA reduces as the book reduces, so I guess that's more, I guess, maybe 10 years or something. It's that sort of length of time for that residual timing difference piece to run off.

Manus Costello, Autonomous

I just wanted to follow up on that DTA point; you talked about time differences. Is there any change in the way that you'll be treating that for Basel III purposes? On a similar point I noticed that you'd shifted slightly your material holdings position. It looks like something's happened potentially with Ping An in the second half of the year. I would if you could explain what's going on there.

Iain Mackay, Group Finance Director

So the DTAs as you know have special deductions against them under the regime of capital, under Basel III. We would expect to in effect utilise substantially all of those deferred tax assets through the phase-in period of Basel III, so by the time we get to the 2018/2019 perspective we would expect the impact of DTA special deductions to be minimum.

Manus Costello, Autonomous

The guidance you gave about the fully phased number at the Investor Day, I think 25-30 bps, that's the same; there's no change in treatment in DTAs in the US?

Iain Mackay, Group Finance Director

It's the same; it's the same. So, the treatment of DTAs has not changed; the character of the DTA hasn't changed. It's still largely made up of the disallowance or the timing difference between what is booked for accounting purposes in terms of loan impairment charges and what is allowed and chargeable for the loan, so that accounting treatment, that capital treatment has not changed in the US; that tax treatment has not changed in the US. So any guidance around Basel III phasing in as it relates to deferred tax assets on the US has not changed.

Manus Costello

And on the holding reduction change between H1 and H2?

Iain Mackay, Group Finance Director

In 2011 it's probably to do with SDB, isn't it?

Russel Picot, Group Chief Accounting Officer

I was just looking at the year-on-year movement. I mean the deductions of unconsolidated investment are pretty static.
[Cross talk]

Manus Costello, Autonomous

It went up in the first half and then down. I wonder if it was in a sense a reclassification.

Russel Picot, Group Chief Accounting Officer

No, that is mainly where we take the investment in insurance deductions.

Manus Costello, Autonomous

Was there some currency movement in there?

Russel Picot, Group Chief Accounting Officer

I mean the biggest piece is obviously our investment in Ping An. I don't have the half-on-half numbers, but the year-on-year numbers are pretty much unchanged actually, so there might be something, something on currency, but we can check those details and come back.

Christopher Manners, Morgan Stanley

It's Chris Manners from Morgan Stanley here. I just wondered if you could talk us through some of the crosswinds impacting the net interest margin and particularly what's going on in Hong Kong.

Iain Mackay, Group Finance Director

In terms of Hong Kong particularly – well, I mean overall for the Group, gross interest margin came total year 2010 from 268 to 251. Specifically in Hong Kong, which covers the whole of the region, so the Hong Kong banking group if you like, we had an expansion of the net interest margin from 183 to 191 year over year. If you look at how that splits out broadly between Hong Kong and the rest of Asia Pacific, you saw some narrowing, some compression of net interest margin in Hong Kong; critically, as you saw, some more movement both market wide as well as within HSBC to HIBOR-based products, where the pricing tends to be a little bit tighter on that front. As you know, anything on the asset book had a direct impact on net interest margin, because really nothing is happening on the liabilities side of the balance sheet in Hong Kong in that regard.
Outside Hong Kong we saw expansion both on asset and liability in a number of key markets – Australia, India, and mainland China in particular. We saw some uplift from policy rates in those countries and we also saw the opportunity to re-price both in terms of local currency and US dollars. US dollars was a fairly scarce resource, particularly in the second half of 2011 in many of the Asian markets and became more scarce as the year moved on, so the opportunity to re-price in some of those markets in US-dollar-based products was particularly notable and we got pick up in the liabilities

side, most notably in those countries where you saw policy rates move.

Christopher Manners, Morgan Stanley

And in terms of where it's going to go?

Iain Mackay, Group Finance Director

Hong Kong I think it is reasonable to assume we are dealing with a fairly static situation. I mean I think we are for the foreseeable future linked to the US dollar. Certainly the HKMA is working very closely with the industry to try and manage the extent of borrowing that is done in HIBOR-indexed products, but I would expect to see slight movements up, slight movements down sort of around a mean in Hong Kong. It's actually been tracked and then in Hong Kong over the last two or three years it's been fairly stable, so it tends to float around a few points up or down. In terms of the rest of Asia Pacific, you know again, I think there are from time to time, you know, strong opportunities to re-price in that market. It's still very competitive, but if you've got available dollars in particular, you tend to be at somewhat of an advantage in many of those markets. Again, you are beginning to see some policy movements by central banks as relates to managing some of the pressures economically in that region and an increasing interest rate environment, where we carry surplus deposits in virtually every business in that region, well, every business in the world for that matter. That's a good thing from an HSBC net interest margin perspective.

Alastair Ryan, UBS

Thank you, Michael's in the depths of footnotes; I'm just doing the pictures, so slide 14 – as Basel III happens to you and doesn't happen to a number of your major US competitors in investment banking directly, you know, because they're not really taking it very seriously, right, six, seven, whatever …

Iain Mackay, Group Finance Director

Basel I really, when you think about it.

Alastair Ryan, UBS

I'm just trying to get a sense, because it's – how that impacts your capital allocation, your thoughts about the desirability of the business – I'm not harping on about rates and credit – maybe I am, but, you know, doesn't seem like they are making you a particularly good return. You've got lots of parts of the world, where you're, you know, long dollars, which other people aren't, you know, all that trade finance stuff I'm sure we all get. It's just whether you're moving the bank in response to that, because it's not immediately evident in last year's results that there's been a great deal of that gone on and whether, you know, it's too early for us to have seen it or the mitigation number might end up going up, because you run smaller inventories. You know, it kind of, to your point, you're [inaudible] in rates. I mean it's not clear [inaudible] the rates product any more as a credit product. You would have less of it even if you were still in the market. It's just that kind of flow through.

Iain Mackay, Group Finance Director

So, this is going to be a really boring answer Alastair, but it's what we do. We provide a little bit more disclosure round this, but what we're doing continuously, whether you call it five filters or call it managing the business, is looking at return against risk-weighted assets. That's informing the decisions at a product level, about where we put capital available to us and it's informing our decisions about which lines of business we're in, so it would be disingenuous to say that we're not giving a very thorough examination of certain of the Global Banking and Markets businesses, whether it is under a Basel III construct or whether it's under whatever ICB ends up being and what the return on risk-weighted assets opportunity is for us in those businesses. Our decisions thus far and I would dare to say that they will continue to be informed by what we see as not only current return on risk-weighted assets, but also the opportunity for the future. In terms of – you know, you look at Basel III and you look at the phase in, well you look at the impact of Basel 2.5 in terms of stress VAR, in terms of the risk-weighted-asset impact on re-securitisation, if you look at the phasing in of the counterparty valuation adjustments coming in over the course of 2013 and beyond, they may have a very direct and purposeful, that's what they are designed to do, but they have a very direct impact on our trading businesses and as a consequence of which Samir and the team are focussed on are there model changes, business model changes that are necessary and even if those business model changes could be effected in a manner that allows us to serve customers in a way that customers need to be served, can we actually make the returns on risk-based assets triangulating back to the return on equity range of 12-15% that we accept for the firm?

So that's how we approach it, and I think one of the disclosures that Russell and the team came up with and Russell probably knows the page it's in, but we actually did put – you know, here's the return on risk-weighted assets for the Group; here's the return on risk-weighted assets excluding the effect of legacy credit, which carries about 65 or 70 billion of risk-weighted assets and excluding the effect of the runoff portfolios in CML, which now is about 130 million risk-weighted assets. That hopefully gives a little bit of drill down on what we see clearly as runoff portfolios, but you shouldn't take

away from that those are the only things that we're looking at in terms of having a mitigating effect in terms of the impact of Basel III. There's a broad range of other activities that Samir and Gerard and the rest of the team are looking at in terms of… and when we come to strategy there, we did not go beyond 2013 purposely in this deck for two reasons – one, we want to give this a little bit more thought, driven by what's going on in regulation, before we talk about this, if we talk about this in greater detail at the Investor Day on May 17, because the uncertainty in the regulatory environment about exactly how – how certain aspects of calibration around CRD4 are effected, what is the impact of ICB within – so flip back to Basel III, how buffers are implemented. So, when we get to 2016 and we're going to be implementing countercyclical buffers, if we're still looking like the sick dog of the world from an economic perspective, the theory behind the countercyclical buffer was that it would be implemented in good times, when people are building capital, to cater for stress times. Well, if we're still suffering stress and problems in 2016, are they still going to require us to implement the countercyclical buffer or will some really wise, forward-thinking person say, 'You know what, we will implement it, but it's going to be a negative buffer. We're going to dig into, you know, whatever it is, the 9.5%, 10%, 10.5%, of core tier one that you're carrying and say, you know, in this environment we're going to drop that by 30 basis points, or 50 basis points, and try and stimulate the supply of credit to the marketplace,' but it's that sort of debate that we're going through internally and it's very specifically the reason we didn't take it beyond 2013, because there's just too much uncertainty.

Bruce Packard, Seymour Pierce Limited

Thank you. Bruce Packard at Seymour Pierce. You know, could you just give me a little bit more help with these large movements in derivatives on the face of the balance sheet?
You know I understand this argument about it's to do with market volatility; it's netted off, so there's no credit risk, but when I try and explain…

Iain Mackay, Group Finance Director

No, I wouldn't say there's no credit risk. If you net this out and look at this as a net of about 60, 50-60 billion I think it is; there's a table in there that lays that out. When you see that movement in derivatives, it is driven by the narrowing and widening of spreads in the marketplace, and some market movements. It is not necessarily that we have got a much higher stock of derivatives in place, although clearly through many of our market-making activities within the Global Banking and Markets business in terms of hedging our own exposures as well as putting derivative structures in place for clients' transactions, the derivatives are used fairly extensively, but the degree of movement is to a significant degree driven by volatility and movements in the marketplace.

Bruce Packard, Seymour Pierce Limited

But what's actually going on?

Iain Mackay, Group Finance Director

So spreads are narrowing; spreads are tightening. Your derivative is a mark-to-market instrument, so probably the best analogy I would come up with is the fair value own debt or the non-qualifying hedges; we use non-qualifying hedges. Those are interest rate swaps; they are there to hedge our long-term interest rate exposures, principally on the consumer and mortgage lending portfolio in the US. As long-term interest rates in the US go down, we've got pay fixed received variable and we've got pay received fixed interest rate swaps and they're all long dated or most of them are long dated. As the long-term interest rates in the US go down, as they did in the second half of the year, the value of that derivative goes down significantly. As those interest rates come up, the rate of that derivative goes up significantly, so it's there – it's an economic hedge on our interest-rate profile of that mortgage portfolio. As the profile of that portfolio lengthens, it's got more impact from long-term interest rates. So the derivative, although it is a non-qualifying hedge from an accounting perspective, it serves the purpose of hedging our interest rate on that business. Every other derivative that we have on the book has basically the same mechanics in it.

Russel Picot, Group Chief Accounting Officer

If you look at the actual notional contract in our trading book – I'll give you page references if that's helpful, so page 363 shows that the total stock of trading contracts HSBC entered into went from 23 – I'm going to get the size of it wrong, but it's – it looks like it was 23 trillion or something – 25 trillion.

Bruce Packard, Seymour Pierce Limited

Sounds about right.

Russel Picot, Group Chief Accounting Officer

Yes, that sounds right. If you look at the fair values attached to that, they move from 380 to 628. Okay, so the stock went up sort of 10% and the actual fair value went up whatever that is, so it's like 80%, and the biggest single move was interest rates, which went from 278 from 510 and interest rate fair values are driven, unsurprisingly, by credit spreads. The other relevant

disclosure then is the VAR, which we give a graph of daily VAR, which gives you a sense of volatility and volumes. As Iain was saying, if you look at then the actual credit risk, I mean when you net collateral and master debt agreements, that's actually fallen; so that's gone from 63 billion net to 40, so the credit piece of that's gone down.

Rohith Chandra-Rajan, BarCap

Rohith Chandra-Rajan from BarCap. Just coming back to your comments on risk appetite, you sort of indicated a reining in in Hong Kong and Latam in the second half of last year. I'm just wondering if that is consistent with current view, so going into 2012 are you thinking the same way about risk appetite in the second half.

Iain Mackay, Group Finance Director

It‘s very relative to each line of business. So, if you think about retail banking or particularly consumer finance in Brazil, we probably have a more constrained risk appetite certainly than we do in commercial banking and global banking, where we see and continue to see an opportunity for growth in commercial banking and global banking activities in Brazil, which continues to be significant.

If you look at rest of Asia Pacific, it's relative to the development within the economy and what we see in terms of, not so much the opportunity, but the opportunity for quality in line with our risk appetite. So, we absolutely continue to seek fairly significant opportunities for growth in Hong Kong, but more muted. I think we would be surprised if we saw a GDP in Hong Kong much more below the variable single digits this year. We talked to some Hong Kong commentators and they even believe there may even be one quarter of recessionary numbers this year. You're talking about GDPs of probably in the 2-3-4% range for Hong Kong this year. So, that represents, from our standpoint, growth, but certainly a more constrained rate of growth in Hong Kong than was certainly the case in most of 2011.

You look at the rest of Asia Pacific, again GDP is much more robust than virtually everywhere else in the world, but there are nonetheless little bubbles that we keep our eye on around certain markets, which – as a consequence of which the risk appetite is adjusted on a country level, a product level, a business-line level based on trends that we see emerging and that's the role that our economics team and our risk management team play with the business teams around how we time this right. Now, sometimes we get this absolutely on the money and sometimes we don't quite time it properly. So the risk appetite is not an absolute; it moves with the conditions that we see in the marketplace and the demand that we hear about from customers and the kind of business we hear. So, broadly speaking our risk appetite would continue to be very positive in most of our Latin American markets, most of our rest of Asia Pacific and the Hong Kong marketplace.

The Middle East, the recovery is strong, but it's very focussed on the Emirates, very focussed on the Emirates, so, you know, there is a good deal of caution there, but, you know, again, we continue to see the Middle East as probably having a – again, who knows how that's going to play out, but we've got a reasonably positive outlook for the Middle East.

There are parts of the business in the United Kingdom on which we continue to be very positive. There are parts of the business in France and Germany which continue to be positive, but, as you can imagine, our outlook there is considerably more constrained than in Asia and Latin America.

North America, commercial banking is a significant focus for the team. We grew that business successfully both last year and the year before. There is an opportunity to redeploy some of the capital coming out of the cards disposition into that business and the trajectory for growth that we see, particularly in West-Coast-based businesses is significant. So, it is very much region by region, country by country, product by product.

Rohith Chandra-Rajan, BarCap

And in terms of impairment trends, just relative to where you do see heightening risk, sort of, would that take you towards – you know, across a lot of the emerging markets, particularly in Asia, impairments are very, very low, so trajectory towards a normalised levels, or moving inside normalised levels?

Iain Mackay, Group Finance Director

Yes but very slow. So, if you look at Hong Kong for example, the loan impairments, the provision, 40 basis points. That's up two basis points I think from the half year. If you look across, the other markets in the rest of Asia Pacific continue to be at cyclically low levels. We would expect some kind of reversion to the norm, but I would also have to say that, particularly within the rest of Asia Pacific, we have seen no adverse credit migration worth talking about at the moment. In Hong Kong a little bit of adverse credit migration in commercial banking, but only very, very slight. In Latin America some movements in Brazil, but it tends to be in the lower end of commercial banking and in the retail banking/wealth management space, but very much within the bounds of normal and manageable. As you can imagine, Europe and the UK we are watching very carefully, but there is nothing to suggest anything particularly worrying at this point. However, were there

significantly higher interest rate environments in the UK I think it would be very worrying for a lot of us.

Rohith Chandra-Rajan, BarCap

Thanks. Can I just ask, on the ICB, I appreciate we are a long, long way away from any sort of firm conclusion. I'm just wondering how your thinking had changed after the Government's update in December?

Iain Mackay, Group Finance Director

The Chancellor's autumn statement, late autumn, was encouraging, but it will depend at the end of the day what gets put into legislation and how that legislation is then implemented and regulated by the PRA. So, at the moment, as I'm sure you know, there's a – there are some 22 work streams being examined by the Treasury. Representatives from financial institutions across the UK are involved in that process. We expect or we've been told to expect the White Paper sometime in late spring and then there'll be a consultation period of a month or two and at the moment an expectation that there will be legislation in the autumn. So the words – you know, the discussion with Treasury and the words from the Treasurer are encouraging, but I remain to be convinced. There is – let's put it like this, from what the Chancellor says to what we see happening on the regulatory front lines are quite different, so we'll wait and see. We'll keep working at it.

Raul Sinha, J.P. Morgan

If we can stay on that topic, what's happening on regulation and particularly focussed on what the FSA is working on, particularly in respect of commercial real estate, I mean obviously you have, you know, 400 billion type scale of exposures globally on CRE. How does the FSA's approach impact the way you do that business; does it have any impact at all and is there any impact on your risk weights?

Iain Mackay, Group Finance Director

As yet, none, because they've done nothing. We have three main centres for commercial real estate – the US, the UK and Hong Kong. That's split reasonably evenly between the three poles. Hong Kong tends to be a bit heavier. If there were a re-slotting exercise on risk-weighted assets for commercial real estate, the effect in terms of risk-based assets to our balance sheet would be – to our capital ratios would be fairly marked. I mean, manageable, but fairly marked. From our standpoint we have made the point of view fairly clear that if they want to initiate further deleveraging in the UK economy and make it even more difficult for a small/medium enterprise to obtain access to credit – because funnily most small/medium enterprises do require facilities to do their businesses out of, and when you look at the composition of our commercial real estate portfolio, that's where it is. So, if the intent is to drive further deleveraging in the UK economy, fire away chaps, great idea. I think that's beginning to be heard in certain quarters, at least in the Bank of England if not in the FSA.

Raul Sinha, J.P. Morgan

But the message from the other banks seems to be that they are resigned to the fact that it's going to happen and they're telling us what impact it will have.

Iain Mackay, Group Finance Director

Well, we're not inclined to give up on that discussion, because we think it's fundamentally bad for the British economy, a fundamentally bad decision. Is it manageable in the context of capital/risk-weighted assets? It would be one more aspect of mitigation that we would have to focus our attention on, so it is manageable, but it is not insignificant in terms of the risk-weighted assets it would add to our capital ratios.

Russel Picot, Group Chief Accounting Officer

I mean, if you look at the technical – the broad sweep of the technical proposal, this was obviously a consultation that unsurprisingly we had to present our views in and our views quite clearly, as Iain said, expressed that perspective, but also that – and you could make this comment about one or two other pieces of proposal coming out of the FSA – it is a remarkably UK-centric piece of thinking, and if you were to try and take what they proposed and apply it to some of the other major markets, the structure of the commercial real estate business in those markets is quite, quite different from the UK, just the whole structure of the length of tenancy agreements, etc. So, that doesn't really come through that draft piece of thinking out of the FSA.

Raul Sinha, J.P. Morgan

Is your argument or push back basically that this should not be implemented globally and this should be an UK-specific change or is your argument that it is fundamentally wrong?

Iain Mackay, Group Finance Director

The latter. The HKMA would be slightly upset by this being applied globally, because they would see it – there are different RWA rules in virtually every jurisdiction around the world. But real estate is – both residential and commercial real estate – is treated differently under HKMA rules compared to that which is being proposed. Now, at the moment the alignment is very close between the FSA and the HKMA. Whether with

re-slotting activity there would be a very significant divergence in rules, and what Basel II has attempted to encourage is convergence, not divergence. This is something that would be a concern for some of the regulators elsewhere in the world – the US and Hong Kong as far as it relates to us being the two most other interested parties in this debate. So, it is an area where we have consulted broadly. We will continue to make our points of view known whether it's the FSA, the Bank of England, the Treasury or Government, so we think this one's extremely important, because, if you look across the piece, the way that most British banks have managed through this last period is they've just deleveraged like maniacs. So, when you look at their capital ratios [inaudible] profits, because they try and [inaudible] the balance sheet. If we want to go further down that route then, you know, this is the right sort of regulation to make that happen. The most important aspect is, to Russell's point, it doesn't reflect the nature of the underwritten risk and the structure of the product that's out there. So, we'll just keep working on it. You can't give up on these things. Some things you just can't be bothered, because it's not important, but this is important from a policy standpoint.

Thomas Stoegner, Macquarie Capital

Just a quick question on the commercial banking loans and making profit this year, is it still a good way to think two times GDP growth is your growth in the commercial banking zone? And then in the second half of this year, did your risk appetite decline, so did you roll over some of the trading loans? What happened, because it's quite sharply down I think currently; it's an important thing to figure out, if you got a bit more conservative, or if there was a lack of demand particularly in Europe.

Iain Mackay, Group Finance Director

If you talk about Europe momentarily, demand hasn't been particularly robust. Now, in Europe and particularly in the UK we grew net lending from a commercial banking perspective. Year over year we grew net lending, not half over half, but we grew net lending year over year. However, when you look at appetite for commercial lending in the UK, in spite of what you read in the newspapers and hear from politicians, demand is fairly muted. If you look at CMB overdraft utilisation within our business, for example in the UK, it has actually declined year over year by a couple of percentage points and utilisation is already sub 50% – sub 40% in actual fact. So, when you think about access to working capital, liquidity for corporates, the easiest way and the quickest way to do that is through an overdraft facility and utilisation is low and going lower. That said, we did within the UK grow our net lending to SMEs by 4%, when the stock raised on data that came out of the Bank of England went down 6%.

There was a very specific technical element impacting half-over-half numbers in Hong Kong and that was driven primarily through Hang Seng, where there was a RMB/US dollar trade product that was developed very rapidly in the first half of the year, which was really addressing a desire to have dollars available in Hong Kong to serve the deposit base of renminbi in mainland China and that was frowned upon by the HKMA. So they tightened up regulation around that in the second half of the year and it was a trade-related product, so when they tightened the requirements around it, the product stopped, but the runoff, it is a relatively short-dated product, it's a sort of 60, 90, 100 day product and so there was a significant runoff of that, second half over first half, which led to basically, I think, once you took out the effect of currency and the effect of that rundown, you had growth of about 1-1.1-1.2% in Hong Kong commercial lending in the second half of the year. Now, that said, we also said at the half year and again at the quarter that recognising that there were certain areas where we saw a fair bit of heat in the economy and we'd seen very rapid growth in the first half that we were going to pull that back a little bit in the second half of the year and we did.

Thomas Stoegner, Macquarie Capital

Is it a good idea to look at the GDP at least for the faster growing markets?

Iain Mackay, Group Finance Director

GDP tends to be a good indicator. I wouldn't give you a multiple of GDP as something to guide you, but if you look around the world and you see where our presence is and where you see significant economic growth, I think it's a reasonable assumption to assume that our commercial banking and global banking teams will be fairly active in those markets.

Thomas Stoegner, Macquarie Capital

Just a really quick on your consumer finance portfolio, can you give us an update when you think it will run off?

Iain Mackay, Group Finance Director

When it'll run off? Well, let's see – they're 30-year fixed-rate mortgages. I think we've got… we've got about 4% of variable rate mortgages and I think we've got about 4 billion of second liens in that portfolio and the rest is all fixed rate, 30-year mortgages, so somewhere between now and 30 years. You know this is running down; it's dropped 9 billion from this time –

from the end of last year, so I think if you grind through the pure numbers…

Thomas Stoegner, Macquarie Capital

I think I heard that it should reduce by 50% in five years.

Iain Mackay, Group Finance Director

That's correct, 5-6 years. When we look at this portfolio as we – if I were to embark on speculation for a moment – as we see hopefully, with five big settlements out of the way on the foreclosure front, the next round of settlements being worked thorough, you would like to think that this, over the course of the next year or so, will get the foreclosure markets working, the foreclosure processes working at full speed again in the US. That should have the effect probably in the short term of putting some stress on the HPI, but it also should clean out that stock and get the HPI moving in the right direction and get buyers' confidence back, you know, if they're buying now, they're not going to see a property that's 5-10% less valuable in a year or so's time. I think moving these settlements through and getting foreclosures working again will have a positive effect. There are a broad range of measures, which the US government has got going behind the scenes in terms of getting the private sector to play a bigger role in… so, one example is lease-to-buy activity, where they've got large swathes of properties that have gone to foreclosure being purchased by investors to lease them. So it's buy-to-lease, not lease-to-buy. It's basically building – they believe that that proportion of people, who own their homes in the US today will decline quite significantly over the next 10-15 years. So, there is effort by both private investors and the government, with a fair deal of incentive coming from the Government, to get investors to go out there and do that buy–to-lease and create an inventory of single family homes in the US that are available for rental over the coming years. What I would expect that to do over the course of the medium term is have a fairly positive effect on secondary market pricing. So, one of the things that we have been doing for the last three or four years and will continue to do is that we slice and dice this portfolio almost continuously looking for opportunities to sell small envelopes of these loans to interested investors, either from a purely financial investment perspective or from a buy-to-lease perspective. So, we will – we are and will continue to look at ways to accelerate the runoff of this portfolio, but with a very sharp eye on the net present value of those transactions.

Nick Collier, Head of Investor Relations

Ian, we've come to time, so unless there's a very quick question…

Michael Helsby, Bank of America Merrill Lynch, Merrill Lynch

A last very quick one …
I guess six months ago we all sat round this very table and I left that meeting feeling – with a very strong feeling that you felt that consensus was in the wrong space. My observation today is that actually you kind of feel like it's broadly about right. Is that fair?

Iain Mackay, Group Finance Director

I'll give you a philosophical point. I won't answer your question directly, because I'm not inclined to do that. But I'll give you a philosophical point. What we would very much like to do is provide you with information that helps narrow the consensus. What drives, I think, all of us nuts – and it was frankly driving me nuts through most of January and February – I'm sitting watching the stock price go up and up and up and up and the number of times that Stuart showed up in my office and he says to me, 'Well, you know what's going to happen on the day we announce our financial results', right. So it came off 3.7%, which was more or less what we expected to happen. I think what Russell and the team and a lot of them sitting around the room are trying to do is to improve the quality of the disclosures and what we disclose and the detail about what we disclose, so that you can interpret that hopefully more narrowly and clearly, so that we can help build a consensus that we think is going to be in line with what we actually can accomplish over time. So the effort from the team in this room to continue to improve the clarity and, if you like, the quantity, dare I say it, of disclosure hopefully helps guide thinking, then we'll continue to try and improve on that. I think it would have been perhaps wishful thinking on our part to say that by providing quarterly information for a couple of quarters we'd miraculously, you know, help everybody understand the business, but I think we'll continue to not necessarily build on the quantity of what we do give you at the quarters, but hopefully try and provide it with the commentary that helps to give you insight as to what's going on.

Nick Collier, Head of Investor Relations

And on that philosophic note, thank you very much everybody; thank you very much for your time.

Forward-looking statements

This 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 our Annual Report and Accounts 2011. Past performance cannot be relied on as a guide to future performance.