Post Interim Management Statement meeting with analysts

Questions & Answers

8 November 2012, 10.00 am GMT

Guy Lewis, Senior Manager Investor Relations

Good morning everybody. Thank you very much to everyone for coming today. Just as a quick introduction, I'm sure you know all of the HSBC team: we've got Iain Mackay who is the Group Finance Director, Russell Picot, Group Chief Accounting Officer, supported by Gavin Francis and Nicole Lee. This call is being recorded and we are having a transcript made which will be available on the website shortly after. If I can just ask, if you are asking questions, please can you wait for the microphone to come around so that the people on the phone lines can hear you. And with that I'll hand over to Iain to kick off.

Iain Mackay, Group Finance Director

Okay. Thanks everybody for coming along. I was sort of faintly hoping that nobody would show up because we had answered all your questions already but that is clearly not the case. Anyway, I have no particularly additional comments to make other than the fact that, when we were looking at our underlying performance, both for the quarter and on a year-to-date basis, we're very happy with the progress that the Group is making from a strategic perspective, and in actual fact in what is inevitably fairly difficult economic times, the business model for the Group, which is designed to be able to deal with some of that difficulty, is actually adapting and performing quite well.

Clearly, within the underlying numbers we had two large expense items coming through. Well we've more than two large, but two very notable items coming through in the quarter which was the further adjustment to the PPI reserve for UK customer address and the addition to the provision for fines and penalties in the United States as it relates to anti-money laundering and OFAC sanctions matters. That is included within our underlying numbers, but notwithstanding that we are happy with the progress that we're making. We are equally cognisant of the fact there remains a great deal to be done. With that I'll be happy to take your questions.

Chris Wheeler, Mediobanca

Can I jump in first? Can I ask some questions on the US because you've kind of lead us in there? But could, you first, of all just talk a little bit about the available for sale receivables, because I was interested in trying to reconcile how you actually approached that number in the 10-Q.

Iain Mackay

You mean the held-for-sale? The stuff that we reclassified?

Chris Wheeler

Sorry, I used the wrong terminology. But, just trying to work out how it moves from 6.7 to 6.3 – you moved in 700 million of provisions. You obviously moved in some loans. Can you just explain what the mechanics are for moving in and out of that? Is it what is you think is saleable, or is it what you're earmarking?

That's the first question and following on from that, which I'm sure is what everybody else was going to ask anyway, in terms of capital in the US, can you talk a little bit about what you think the excess capital might be in the US at the moment and then give us the usual update on the negotiations you're going to have to go through? And then just finally, on the fine, or on the provision for the settlements in the United States, I think that you were hoping that would be settled before the election, and I am worried which election it is now…

Iain Mackay

Well and truly over, yes.

Chris Wheeler

I just wondered if you could give us an update on when we might actually get the final number.

Iain Mackay

Well, let me answer the third question first because there's not really much I can add above what Stuart's talked about. It's a live set of discussions. We don't know when it will end. We'd clearly be very happy with ending sooner rather than later. But we don't know when it will end; the discretion for how conclusions can be reached here lies entirely with the US government. I think the positive development since our half year numbers is that we are in discussion. And that's clearly what has informed movement from a financial standpoint, but as you'll probably notice our disclosures in this regard remain highly consistent, dare I say identical, with what we told you in the half year. So I can't really tell you more than that, I'm afraid. I wish I could.

As far as held-for-sale accounting goes, it is really a one-time election and the timing of it is informed by a level of confidence around being able to execute that transaction. So it is literally what we hope to sell but it is what we have a high level of confidence that is a transaction that is structured around that entire amount, under IFRS, right? If you look at US GAAP financials, it is a little bit different but under IFRS the entire amount which was net of impairment allowances against that amount, those are transactions for $3.7 billion of non-real estate receivables that has sat or sits within the CML portfolio that is structured, that has been priced, that we have received bids on and that the bids are now being reviewed. And all I can tell you is based on a number of bids and the level of pricing within the bids, our confidence around the transactions is reasonably robust, and we would expect that to happen sometime, if we can really move this along – but it is a slow-moving process because it is operationally very complex – we would love to get it done by the end of the year but realistically I think it's early next year, okay?

Chris Wheeler

No, no – sorry the balance. The balance of that amount in the 10-Q

Iain Mackay

Right, but that's US GAAP. So the balance relates to an amount of defaulted real estate loans, again from the CML portfolio. And under US GAAP, the criteria's slightly different, but again it is a pool of loans which we have structured into a tranche transaction, with three or four separate tranches. The tranches range in size from about $500 million to $750 million. We are well down the path to completing the operational work necessary to execute those transactions, we've priced them but we have not yet received bids in the market because we haven't put them out for bid. That's a process that we'll start in the first quarter of next year. And at their US GAAP they will reclassify the held for sale, and at the time that you reclassify the held for sale you take, in effect, the expected financial impact of that transactional loss, which was recorded in our second quarter financial statements in the US under US GAAP.

Chris Wheeler

And the movement of provisions in and presumably other loans is into that tranche which presumably you're still working on?

Iain Mackay

Yes, and as that moves, but again the accounting for the defaulted loans is once they hit 180 days past due, they are written down to the expected proceeds from the disposal of the collateral, net of the costs to dispose of those assets. So we're dealing with loans which have been written down in effect, to net realisable value, okay? So, as a period of time that passes; to the extent that there is an adjustment to that, if the net realisable value goes up or down that is reflected in the held-for-sale account, okay?

Michael Helsby, Bank of America Merrill Lynch

Can you just clarify: on the 1.6 billion you took in Q2 which was the fair value reduction, was that related to the real estate? How was that split? Can you give us a split of that?

Iain Mackay

I don't have that split. I don't think it's in the 10-Q.

Michael Helsby

Should I assume 50-50 or…?

Iain Mackay

No. We don't have it in our files but we can get it for you.

Michael Helsby

Just from reading the notes, it sounds like it's important where the fair value is, because I get the impression from reading the notes, that the realisable value of the real estate piece is potentially higher than the fair value that you've got recorded. So it reads in the Q. But there's no real comment on the IMS.

Iain Mackay

No. I don't have that data at my fingertips. We'll take a look at that with the US team and revert back to you, okay?

Michael Helsby

No, just on the capital.

Iain Mackay

On the capital the story hasn't changed. I mean, clearly to the extent that we pay fines and penalties in the US the capital will be eroded. The business– at the third quarter – pre-provisions would have been in positive territory. The US Bank would have been in positive territory, so if you think about HSBC Finance Corporation (HBIO), that's the run-off portfolio, the cards are gone and it's CML; that's really all that's left there and we give you disclosures on that; you can follow it very easily.

The ongoing business is the Bank, which is HSBC USA Inc. Pre-provisions, that was in positive territory, so generating capital, not covering its costs of capital but generating capital on an accounting basis, and the capital that we have in the US will be detained in the US, certainly beyond reaching any eventual settlement with the US authorities, through to the point that I think we satisfy regulators that we've met the conditions that they would expect of us in terms of improved levels of compliance. But also, you know, making further progress on the run down within the finance company of the remaining CML portfolio. So any surplus capital that we have there – a) we would clearly expect to pay fines and penalties out of that to the US authorities once that is reached, and I would expect any surplus capital that sits in the US to remain there for certainly a couple of years thereafter, until we've demonstrated that we have the right level of controls and compliance in place and that we've made further progress in running down the portfolio.

Chris Wheeler

Thank you very much.

Chintan Joshi, Nomura International Plc

Can I just follow on those points before we move on please? I just wondered on the transaction that has been classified into held for sale, how much of RWAs do you have behind it and based on the bits that you received, how much capital do you expect to release on that transaction? And the second question, the US housing recovery – shouldn't that bring forward the capital release potentially in North America? I would have expected some change, at least in degree, that the capital release might be a little bit sooner?

Iain Mackay

How complicated an answer do you want to this?

Chintan Joshi

Fairly straightforward.

Iain Mackay

Right, I think you'll have seen, Chintan, from the numbers that Michael mentioned, that our expectation is that we will actually consume capital through the disposition of those assets, right? Although we're recording a book loss, clearly we'll release some risk-weighted assets associated with that. Generally anything sitting in the CML portfolio – although the NRE and the real estate books are slightly different, you can generally take the book value multiplied by about two and a half to three times and come up with the risk-weighted assets that would generally be released. Two and a half times will give you a conservative estimate of that.

So you start sitting around about, you know, if we get 3 and a half billion off you're sort of talking about 8 billion, 8 to 9 billion of risk-weighted assets coming off. In terms of capital release, it will consume capital but it's not at the level that we're recording accounting losses against.

In terms of improvement in the housing market leading to reduction in risk-weighted assets in the US, relating to, if not necessarily a release of capital, an increase of capital surplus, under US GAAP, under US reg, as you've seen in the US Bank financials coming through probably in the last couple of quarters, they do get some relief as the housing market improves. Unfortunately, under FSA reg what we deal with in the model is downturn PDs, downturn LGDs, so the only way you get risk-weighted asset relief through the FSA model is by reduction of your exposure at default. And reduction of your exposure at default is either going to be paid down, charged off or sold, and therefore the focus from our perspective is ensuring that we maintain the current run rate around pay down and charge off, which tends to be around 2 billion a quarter, split 50-50 between pay down and charge off, but then obviously trying to accelerate the rundown of the portfolio through dispositions like the couple of transactions I've talked about this morning.

Chintan Joshi

So one more follow up on that: in the last conference call at H1 stage you said that the theoretical mark to market of the book was something around 10 to 12 billion. Is it the same still?

Russell Picot, Group Chief Accounting Officer

10 to 12. Yes, still the same I think.

Iain Mackay

I think if you look at the US economy, although the unemployment rate has remained fairly high, there are more people coming back into the market, so overall the employment numbers we would have to call mildly encouraging, right, but we've got this thing hanging out there on 31 December, and your guess is as good as mine as to whether the president can actually get the House and the Senate to get their proverbial act together and, you know, reach some kind of compromise that doesn't go over the edge of the fiscal cliff on January 1st. If it does, I think you see a double-dip in employment – well, the US goes back into recession; that's what happens in my opinion.

Let's assume they get to that compromise and they move through January without too much obstruction. Let's hope we continue to see gradual improvement in the employment market and very gradual improvement in the housing market, which is sort of what the Case-Shiller data bears out. Our data is stable, which is good, and therefore I think, you know, our ability to market more of that portfolio, employment improving, holds up the payment rate on that, maybe improves the payment rate, and we'll see it flow through in terms of what we see in performance in loan impairment charges and our ability to dispose of more of the portfolio because, beyond the non-real estate, the focus is to get one transaction of around, you know, 500 million to 750 million of the defaulted real estate loans in the first quarter, and then have multiple recurring transactions of about the same size over the succeeding quarters.

There is no point in the foreseeable future where we could do a block trade to get larger amounts than that out because there's just not the capacity or appetite in the market for it at this stage. Downside risk in the US, the weather's not helping, right? We do have customers in Pennsylvania and New York, New Jersey, the East coast, and we have suspended collection efforts in those neighbourhoods. It's very specific; it's very focused on those neighbourhoods that have been severely hit. So where we have a mortgagee that has had no electricity for the last week, is perhaps not in their house, perhaps the basement's flooded, we are not pursuing them for collection, so we've taken, you know, shall we call it a humanistic approach to dealing with collections with this, because there's no point pushing in these circumstances. Clearly it's only three or four states, but three or four states – I'm literally getting an update from the team every week of where they see delinquencies and where they're seeing delinquencies developing by state. So we're watching it very closely, but, you know, there's a couple of headwinds out there. The biggest, unless we're really in global warming, you know and sort of *The Day After Tomorrow*, that film, you know?

[Laughter]

So, unless we're sort of in that scenario… Assuming we're not in that territory, I think, you know, the weather's a minor blip and it probably will be a blip in our LICs but the fiscal cliff is the deal – that's where all the nice references we heard from Obama last night hopefully will manifest itself in the behaviour over the next couple of months.

Russell Picot

Iain, can I just go back to the numbers – so in the HSBC Finance Corporation 10-Q on page 59, we split out the P&L charge on the US GAAP basis. So, for nine months the real estate's security piece, which was transferred to held for sale – the write down was 1.3 billion and the personal non-credit card piece was 400 million, so that's 1.7 billion gross – so that's probably in line with what you would expect.

Iain Mackay

Yes.

Rohith Chandra-Rajan, Barclays Capital

Just to follow up, actually, on the same line of questioning: just looking at the sort of delinquency levels and the coverage of those in Finance Corporation. So the coverage – the loan allowance obviously drop by 700 million. Just looking at the coverage of the delinquency – so the delinquency was pretty much flat quarter on quarter – I was just wondering if the delinquencies had been adjusted for the unsecured book, because I think again, looking through the disclosure, it looks like the delinquencies were about 0.3 billion or so, and are still included in that number, so it looks on the face of it like coverage dropped from about 67% to 55%, but I think, looking through the disclosure, that coverage on the mortgage book was still sort of 66%, 67%, so I just wanted to clarify that.

Iain Mackay

It is, and I think the important statistic is the coverage of the reservable. So what's included within this, of course, are those which have already defaulted, so you've taken the charge off. So what we focus in on is the reservable delinquencies and the reservable delinquency ratio, the coverage of allowances to reservable delinquent loans remains very high and very consistent; it's over 80%.

Mark Phin, Keefe, Bruyette & Woods Limited

Could we just switch geographies? Rest of Asia-Pacific, I know there's quite a lot of currency impact in there but it does look like maybe that will be reflected in the loan numbers as well I guess; I think that's up about 16 % year on year. So it's really a question of margin generally, what you're seeing within that business, because it looks as if it's still coming off quite sharply; is that fair or is there something else –

Iain Mackay

Mark, if you look at margin for HBAP as a whole, which covers both Hong Kong and China, and in Hong Kong the margins have remained largely stable, but if you cover HBAP in total, net interest margin development for the Hong Kong Bank Group, which covers the whole of Asia-Pacific – you know if you compare, at the end of the third quarter on a year to date basis, net interest margin is 199 and that compares with 2% at the end of fourth quarter 2011. And it compares with 202 basis points in the first quarter of this year, 199 basis points the second quarter of this year, 197 basis points the third quarter of this year. So, quarter over quarter, we lost two bps on the net interest margin covering the whole of the rest of Asia Pacific, and on a year-to-date basis it's entirely consistent with the end of last year.

Mark Phin

Right, okay so the income drop that's coming through in rest of Asia Pacific is just the effect of the –

Iain Mackay

PVIF, right?

Nicole Lee, Head of Group MI Reporting

For the year to date…

Iain Mackay

For the year to date, yes.

Mark Phin

In the quarter specifically, because I think it's come down from about 3 billion to 2.6…

Nicole Lee

I think that was a feature of something that happened in quarter 2; are you looking at quarter 3 versus quarter 2?

Mark Phin

Yes.

Mark Phin

And I think the number you give for the – I think there's a disposal number in there, the effect of the disposal at 188, but I don't know whether that's, you know, there might have been cost and income –

Iain Mackay

So that's sitting within – so the gain on sale of the Thai business was in second quarter or third quarter? Second quarter. So that's sitting in the other income line, in the total revenue line, and that was 188, and that's probably the main type of revenue. 2Q to 3Q…

Russell Picot

On an underlying basis, Q2 discrete we've got a little over 2.6, and then Q3 discrete is down a little bit.

Mark Phin

So it's down a little bit, and the loans are up about four, so that's kind of…

Iain Mackay

So net operating income before loan impairment charges went from 2.8 actually to 2.6. Right, so it is basically the gain on sale of the Thai branch network, I think, that drives it.

Mark Phin

Okay, thank you.

Russell Picot

I think the biggest single swing factor is probably a disposal of an equity position in Q2 in the Philippines.

Mark Phin

Right, okay. Thank you.

Russell Picot

As opposed to fundamental degradation.

Iain Mackay

Yeah if you go through the net operating income, so the one-off transactions as opposed to an underlying trend in net interest income and fee income.

Mark Phin

Okay, sure, thank you.

Michael Helsby

I was just wondering if you could give us a bit of a hand, actually, on seasonality, because I think we're all sort of moving through the quarterly numbers and last year's second half was quite mixed up, – particularly on the revenue line because Q3 was very weak and everything was –

Iain Mackay

Rates and Credit was terrible.

Michael Helsby

But it does look like within GBM you'd expect some seasonality, i.e. Q4 weaker than Q3. Is that reasonable and is there any other strong seasonality on the revenue line outside of GBM?

Iain Mackay

You know, Michael, I don't know how to answer this question because we're learning things this year which we haven't seen in previous years and the question that we have to ask over the coming quarters – is it because of what we've done in terms of changing the structure of the business, changing how we're running some of the businesses, focus around execution? I don't know what it is. But, you know, we didn't see – you know, touch wood on this one – we didn't see seasonality come through LICs in North America. The Global Banking and Markets revenue, which generally in the third quarter is a little bit weaker, actually held up well. And if you forgot about the comparison to the third quarter of last year, which as you point out was atrocious – but if you looked at it quarter-over-quarter it held up well.

So if you took out some of the one-offs – or not one-offs, but revenue uplift that we had in the second quarter, particularly around available-for-sale disposals out of Europe and Asia which, you know, gave an uplift to balance sheet management in those quarters, the revenue coming through the main lines of the P&L has held up pretty well through Global Banking and Markets. October was a pretty decent month from Global Banking and Markets – a pretty decent month for the Group, actually.

Now, as we know, in December, you know, half the Global Banking and Markets team seems to take a month's holiday. But, you know what? This year maybe they won't. This year maybe they won't. We'll see, because there is a change in structure of the business, there is a change in focus from the business, and the question will be: how much market activity is there kicking around in late November and December for the guys to sink their teeth into? I don't think we lack motivation to go out there and try and generate the revenues and make money because they're getting measured the whole way through to 31 December. The question will be: is there sufficient market activity in late December, after Thanksgiving in the US, when things do start to slow down a little bit, and in the UK and Europe leading up to Christmas? But so far, you know, based on overall market level trends, there's not a whole lot of seasonality coming through.

Michael Helsby

And just on the cost line, historically Q4 has always been a big uplift quarter. Now clearly there's a lot going on in costs in terms of what you are doing, but is there any reason to think that the projects that you're going through will dampen that typical 4Q pay-rise type seasonality?

Iain Mackay

The projects we're going through are specifically focused on dampening that fourth quarter seasonality.

Michael Helsby

Well yeah, clearly; it's… But will it – clearly it will dampen, but will it –

Iain Mackay

Will it eliminate?

Michael Helsby

Yeah, eliminate it?

Iain Mackay

You know, I'll probably repeat a remark I made on Monday, Michael, is that we measure the business in underlying. The underlying includes the notable items that are coming through. So, we're not making any excuses for the notable items; we're providing you disclosure on the notable items because we are of the opinion that the items we have disclosed as notable, although they have got some kind of life to them, they're not part of the ongoing run rate for this business, right? God forbid we're paying penalties in the US for the next four years or anything like that. And PPI – maybe that's a more interesting discussion on the PPI front. But the focus is to get a sustainable managed run rate coming through the business that we have confidence in. And we put numbers in the IMS which referred to somewhere between 8.5 and 9.2 billion per quarter[1] and that's what we're focused on trying to manage the business to.

Michael Helsby

Where did you get the 8.5 billion – because you've put that chart up before and it's never been below nine.

Iain Mackay

Oh no, it has.

Michael Helsby

At the half year you've got the underlying costs and you adjusted it for constant currency.

[1] This run rate is based upon the new underlying methodology, that is detailed on page 5 of the Interim Management Statement, and which now removes the operational results from the disposed businesses for all periods. This approach better reflects the results of the ongoing business. Whereas, on page 11 of the 2012 Interim Results presentation, underlying was calculated on the old methodology and included approximately US$0.2bn of costs per quarter relating to CRS and the disposed US Branches.

Iain Mackay

But if you go back to – let me see; I've got a chart in here.

Russell Picot

Iain, can I just add a rider on the revenue while we're just –

Iain Mackay

Yeah, fire away.

Russell Picot

So I think, Michael, the other factor in terms of Q4 is going to be the balance sheet growth. So if you're looking at Q4 2011 versus Q4 2012, you would expect to see some of the pull-through from the residential mortgage growth that we've experienced coming through as well, as well as obviously the customer demand aspects.

Iain Mackay

So third quarter, on that basis, reported through to underlying and then stripping out the notable items, we're at 8.9 in the second quarter; we're at 8.8 in the third quarter.

Michael Helsby

I'm sorry; I was only looking at your chart that you put up at the half year; that's all I've had to work with.

Iain Mackay

Right. So here you go: if you take the operating expenses, that's reported basis, 10,852 second quarter. Restructuring costs of 303; UK customer redress of 929; provision for US anti-money-laundering, BSA and OFAC 700. In the third quarter, reported of 10,278, restructuring of 96, UK customer redress of 353, bank levy credit adjustment of 58, interchanged litigation accrual 133, Asian litigation – which we referred to – 94 and US anti-money-laundering, BSA and OFAC provision 800. You adjust that down, it's 8.9 in one quarter and 8.8 the next quarter.

Michael Helsby

Okay. You might want to check your chart, then, because you did – it's not been below nine. But that's fine; that's great.

Iain Mackay

Okay. So that's what informs it and just getting good discipline around people booking the expenses –when expenses are coming in, we've done a lot of operational work with our payables teams on, 'Guys, stay on top of the accruals, make sure that everything is processed on a timely basis, make sure we're capturing any discounts that are in there'. And it's as simple as going round the lawyers. The lawyers are great lawyers but they're absolutely crap at finance, but going round them and saying, 'Do you have bills sitting on your desk that you haven't processed yet? Get them processed, make sure we've got them' – so it's simple operational stuff so that that we can know what's coming through month on month, quarter on quarter in the cost base and when we know it, then you can do something about controlling it.

Guy Lewis

Perhaps we can just see if there's anyone on the phone line in Hong Kong who would like to ask a question.

Operator
No questions.

Guy Lewis
In which case, I'll hand the microphone down this end of the table.

Manus Costello, Autonomous Research LLP

I just wanted to follow up on the seasonality point on risk-weighted assets this time, because we saw a big drop in market risk-weighted assets in the third quarter, down on year to date but also not that much year over year and last year we saw quite a big pick-up towards the end of the year. So should we expect that gain that you've made in market risk-weighted assets to reverse later in the year or is this the right run rate?

Iain Mackay

So again, when we talk about mitigation of Basel III, the teams in Global Banking and Markets, specifically Global Markets, have spent a lot of time over the course of the year, whether it's restructuring transactions so that there's better netting capability, restructuring transactions just in terms of overall how they're measured from a risk-weighted assets perspective, frankly exiting a number of relationships where when you looked at the returns on a risk-weighted basis they didn't make a great deal of sense. But fundamentally the market risk is driven by the positions that we're carrying within – principally within the Global Banking and Markets team and then driven by volatility that exists within the marketplace.

So some of it you can control, and that which we control we're making I think good progress through the structure of the transactions, the type of transactions, the type of business, the counterparties we're dealing with. We saw lower volatility certainly coming through the third quarter, which is one of the reasons that market risk has come down. And then, again, we're not constraining the market's business on taking positions that meet the return criteria. So when there's an opportunity out there for them to put business on that gives them the right return equation, we're letting them do that. So in fairness, I would expect to see some volatility coming through market risk.

But the underlying from our perspective is making sure that the business that we put on is properly structured to be efficient from a capital utilisation standpoint. And I would say this is an area where the Global Banking and Markets team has done a lot of work over the last couple of years and are getting better at it, but there remains a good deal to be done. A lot of what we're learning in Global Banking and Markets we're sharing, for example, with the Commercial Banking team because there's things that can be learned there as well.

Russell Picot

There's also a technical reason, at December 2011, why you saw the Q4 jump, which was Basel 2.5 came in at the end of last year, so you then picked up the incremental capital charge around the stressed VaR and those other pieces. So that was a one-off in Q4 2011 and you're obviously seeing that being managed down through 2012.

Manus Costello

But this sort of level of 45-50 billion of market risk-weighted assets is where you'd expect to run unless market volatility jumps or unless you decide to take on additional risk?

Iain Mackay

We've got a risk appetite there which is around market limit caps, counterparty limits. We've clearly got measures, whether it's EVE, whether it's you know, you know, VAR/stressed VAR, that we monitor from a market risk perspective, but we don't have a market risk RWA target number out there.

Manus Costello

Thank you.

Raul Sinha, JP Morgan

Just following up on your previous comments, Iain, firstly on litigation, could you comment on the PPI provision? How many months of cover do you have on that and what are your assumptions behind the provision? And then secondly, on GBM, can I just ask about the revenue line? So two parts within that: firstly, on balance sheet management, I noticed Stuart reiterated the 2.5 billion long-term guidance on the call. How do you expect that number to evolve relative to – you know, have your expectations changed regarding the evolution of balance sheet management going forward? And secondly, on Rates, obviously you said did much better than last year, but obviously fell a long way from the second quarter. What is the sort of clean underlying revenue run rate within the Rates business?

Iain Mackay

Right, PPI first. Didn't one of your guys ask that question yesterday?

Raul Sinha

That's why I'm following up; exactly. Because we looked at that and were like…

Iain Mackay

Okay. From a PPI perspective we are building provisions based on the operational data that we see coming through the claims handling process. So as we see claims data coming through and the evolution of that claims data, both in terms of volume of incoming claims, those which are valid claims, the uphold rate against those claims, that is what is informing how we manage the provision for PPI. So it's a very similar approach to managing loan impairment charges in our credit portfolio. It is driven by the operational data and the behaviour that we see.

We've seen an elevated level of claims really the whole way through the summer. We had a small dip in the July/August period, which we expected, related to summer holidays and the Olympics – summer holidays particularly because people generally aren't at home to answer calls from claims management companies when they're on holiday. But we expected that to normalise again in September and October, which it did. So we've seen this relatively elevated level of claims coming in. We would expect that elevated level of claims to continue into the first quarter of next year. We would then expect to see that level of claims start to tail off. One of the reasons we would expect to see the claims start to tail off – incoming claims tail off – is because our outbound mailing programme, which is part of the settlement process – the redress process, rather, with the customers, is ramping up. It really started a couple of months ago; it will continue to ramp up from now really through until about May of next year, at which point we'll hit a peak. Around the end of the first quarter, we would expect to see a crossover between out outgoing mail and incoming claims so that we will be capturing more of the population through our outbound mailing process than, if you like, the inbound claims.

So our reserve is based on that tail-off of claims experience beginning to kick in in the first quarter of next year and then work a gradual tail-down through the remainder of 2013 into 2014. Based on those assumptions, we've got somewhere in the range of 14-15 months' worth of coverage. Should elevated levels of claims experience continue beyond – either increase beyond where we are today or continue beyond the first quarter of next year, we would – you know, we've built a provision based on our modelling of what we expect to see and that's informed by what we see happening today. If there's a change in that pattern then clearly we would need to revisit our assumptions and the reserve within that. Okay?

In terms of Global Banking and Markets balance sheet management, I think Stuart mentioned this on Monday, the balance sheet management team does a great job. We still see the range of balance sheet management on a sustainable, long-term basis sitting between $2.5 billion and $3 billion worth of revenue annually. We clearly will exceed that this year. But within that this year, we had, you know, not insignificant disposables of AFS in the portfolio in the first and second quarters, principally in Europe, which contributed –

Raul Sinha

Is that done now?

Ian Mackay

Well, you always turn that portfolio, right? So you're managing, in the simplest, crudest form, you're managing the corporate surplus of the firm, and the team is out there looking for an investment opportunity that corresponds to how we want to match the book. And as they see opportunities, they move in and out of positions. And that's, in actual fact, what they did notably in the second quarter of this year. So as opportunities exist, they either put positions on or take positions off. So it is – I mean it's an actively managed available-for-sale portfolio, basically.

But we still believe that the long-term trend sits somewhere between $2.5 billion to $3 billion. Okay? Now, in terms of getting to an underlying from a rates perspective, you know, God bless anybody that'll give you that number, because it's driven, as you saw, largely by – you know, we have de-risked across both our credit trading portfolios and our rates portfolio, but they are actively trading portfolios. Again, Stuart put numbers out there around the number of people we've got on those desks and they're down significantly. So the books of business are much, much smaller. We think we've got well-managed positions and risk positions that are highly consistent with our risk appetite, but I would not give you an underlying – I wouldn't even dare give you an underlying for rates or credit trading.

Frederik Thomasen, Goldman Sachs

Just following up on PPI, I was wondering – you're clearly tracking, like your peers, the volume of incoming claims, but I was wondering if you've managed to kind of take a step back and look at the aggregate volume, I guess, of mis-sold policies – so what could be the potential maximum liability. Because I guess you can see what's coming through the door, but you must have a sense, I guess, of what the total backlog is.

Iain Mackay

We know our gross written premiums, but that's it, right? Because again, our position has always been that for the vast majority of our book of business, this product was sold appropriately. The basis on what constituted appropriate sales was changed completely post the judicial review and the process of redress and settlement fundamentally changes the perception, if you like, of what was an appropriately sold product. So to be clear, there is reimbursement going to customers that were appropriately sold product – they haven't filed claims but they were eligible and they were appropriately sold product. So we know our gross written premiums, but the gross written premium doesn't necessarily inform you as to the ultimate claims that you're going to be satisfying. So the claims you will be satisfying is based on people responding to outbound mailing and then responding to claims management companies, or people who have actually not responded to a claims management company, not responded to outbound mailings, but, in the current flow, are part of the incoming claims – so they know they've got PPI policies; they believe they may have been mis-sold; and they're contacting the Bank of their own volition. And we're satisfying some of those claims as well. Some we are; some we aren't. Okay? So I know the gross written premium number but I'm not going to give it to you and I know the compound interest at 8% on that gross written premium number and I'm not going to give you that either. But I will tell you that the compound interest is more than the gross written premiums we ever wrote. It is just ludicrous.

Frederik Thomasen

I hate to push you on it, but there's no way to look at the book and say, 'Okay, out of the PPI gross written premiums, there are certain aspects of the book that we're confident we will never have a claim on because it's been correctly sold and' –

Iain Mackay

No, I would put it the other way round; there are parts of the book that we've looked at which we think are highly susceptible to claims and that's factored in to our current reserve.

Frederik Thomasen

And then secondly, on your cost savings programme, I guess there was a quite material step down in the related restructuring charges in Q3 relative to the run rate of the previous quarters, and I was wondering if you could share with us how we should think about, I guess, the restructuring charges related to the cost savings programme going into Q4 and 2013. So are we running sustainably at a lower restructuring charge now, or is there more to come?

Iain Mackay

So Fred, I would answer that question by saying that we are – I think Stuart mentioned this on Monday. We are about three-quarters of the way through what we're doing in terms of dispositions, closures of businesses, withdrawal from product lines, organisational effectiveness in terms of the four cost efficiency programmes of technology, global functions, process improvements, so on and so forth. So of the major restructuring effort we're about three-quarters of the way through. There continues to be not insignificant amounts of work to do in Retail Bank Wealth Management, not insignificant amounts of work to do in North America, whom we have – as I mentioned previously, whom we'd given extra time, recognising that they had a number of other issues which, frankly, are more important and more pressing and had to be dealt with, but Irene and the team are now very focused on the restructuring of the US business. But we're about three-quarters of the way through it.

As was the case in May 2011 and again in 2012, I am loath to put numbers out there around restructuring. But I think what I did say in May 2011 is that the sustainable saves would significantly outweigh the structuring costs and that has proven to be the case thus far.

Ronit Ghose, Citi

Just one question to follow up on the previous question on the rest of Asia-Pacific so I'm completely clear. I understand that in the second quarter you had one-offs that were positive, but are there any negative one-offs in the third quarter in the rest of Asia-Pacific, apart from divestments such as Thailand?

Iain Mackay

Nothing material.

Ronit Ghose

Nothing material in the third quarter. So that's the new run rate.

Iain Mackay

There's not a material one-off, if you like, coming through in the third quarter, is there? It's just the sale – yeah, the gain on sale in Thailand.

Russell Picot

There was a litigation charge in Australia.

Iain Mackay

Ah, yeah, there was one Aussie charge, but that's in the operating expense line.

Ronit Ghose

In the expense line, right.

Russell Picot

In opex, but not in revenue.

Ronit Ghose

Right, okay. Thank you. The second question is on – going back to the US. The question I asked on the call on Monday was to compare the guidance you've given on the US GAAP, that you might have up to a 400 million provision charge, and IFRS accounting. In layman's terms, can you explain what the difference is – why you're going to have to take a US GAAP charge but not an IFRS charge?

Russell Picot

The regulatory influence on the level of loan loss allowances held by the American banks is, as you are probably all aware, reasonably considerable. So there have been conversations between management and the US regulator, so we're looking at the level of US GAAP provisions against a broader industry norm, and that's what's marked in this document.

Under IFRS, there isn't, at a Group level, that sort of regulatory – line up with an industry standard isn't really what you do; what you actually do is to come up with a fundamental methodology that complies with GAAP and we do look at peer group. And then from time to time, we will continue to assess the appropriateness of the IFRS methodology. So there isn't an automatic read-across from a US GAAP change in the actual

GAAP number on loan loss and IFRS. So you saw that in two thousand and – get my years right – earlier, when the US GAAP was changed on troubled debt restructurings, and at that point, US GAAP and IFRS loan loss provisioning split fairly radically. So that's why you're not seeing some sort of automatic read-across. So the IFRS methodology's definitely – you know, we look at the level of inherent losses, how long it takes for those losses to emerge, etc. So it's a very principled approach.

Ronit Ghose

Thanks. And just one last question on… What's your best guesstimate on CRD4 in terms of when we'll actually get a document that we can all work on, or you can work on?

Iain Mackay

In the implementation. So it has definitely been postponed to 1 July next year at the earliest and possibly as late as 1 January 2014. And Russell and I learned that at a meeting at the FSA last week, so I think it's reasonably reliable information, but –

Ronit Ghose

Okay. 1 July at the earliest.

Iain Mackay

1 July at the earliest and possibly 1 January next year.

Ronit Ghose

Great, thank you.

Iain Mackay

Okay? We're all looking forward to that.

Russell Picot

I am.

James Chappell, Berenberg Bank

Hopefully three relatively simple ones. The 133 you referred to that's to strip out of the cost, can you just repeat what that was, that provision?

Iain Mackay

Yes.

James Chappell

Because you said the 94's in the rest of Asia-Pacific and the disclosure –

Iain Mackay

Oh, right, right. No, there were two and this is just part of ongoing operating expense, but they're significant items. I mean we have litigation, like every other firm, going on. We've got two – for which there were movements in judgement, if you like, and they're part of big class action suits that – we're part of a big bunch. And there's one in the US which relates to MasterCard/Visa and interchange, which is an extremely well-publicised item; there are disclosures about it in our financials as well as most other banks in the US, and we picked up a provision and that was 133, I think, in the US. And then there's a large litigation – again part of a class action suit – impacting the whole of the banking industry in Australia, for which we picked up another 96 or 99.

James Chappell

Okay. And you sort of talk about them stripping them out, but you haven't disclosed them in the notable items.

Iain Mackay

They are part of the total notable items, yeah. But I mean they're small when compared to PPI and US provisions.

James Chappell

Yeah. And the asset write-backs within GBM; which location? Europe – were they all in Europe?

Iain Mackay

Yes they were.

Russell Picot

A bit in America, but mostly Europe.

Iain Mackay

Very small amount in the US.

James Chappell

And what were they in total? Can you give us an idea?

Iain Mackay

20-30.

James Chappell

Okay. And so the provision decline Q3 on Q2 was more than just the asset write-backs. What else was in – was there anything else within that?

Iain Mackay

On the available-for-sale?

James Chappell

Yeah, within GMB. Because the provisions were suddenly positive in 3Q from your minus 400 in 2Q.

Iain Mackay

Right. So principally it was an improvement in the quality of the available-for-sale book. So if you looked at the SICs and the SIVs – so part of the legacy credit within Global Banking and Markets – if you go back to our disclosures on the available-for-sale reserve, which, if you go back to 2008, was it 18 billion debit? It is now 200 million credit, for the first time in several years. So that reflects, frankly, pricing improvement in the underlying securities within those vehicles. Now there are lots of different elements within that which we provide nauseating amounts of detail at the full year and the half year but we don't at the quarters, but it's the underlying performance of the available-for-sale securities within those portfolios that are the main driver of the reduction. And again, in previous quarters I think there were one or two individual client provisions that came through the credit line which were not repeated in the third quarter of this year.

James Chappell

And they would be in both US and Europe?

Iain Mackay

Well, the Global Banking and Markets in previous quarters, there was one in the Middle East –

Russell Picot

There were some in Asia.

Iain Mackay

There was Middle East, there was Asia; there were none in the US and I don't think there were any in Europe either last quarter. No, the second quarter it was mostly the Middle East and Asia, actually. But this quarter, from a credit provisioning perspective, was – within Global Banking and Markets was very – actually, Global Banking and Markets and Commercial Banking were pretty clean. There were a couple of small items in Commercial Banking, but again, individual clients that were restructured.

Russell Picot

Can I just add something on the AFS point?

Iain Mackay

Fire away, yeah.

Russell Picot

I mean we – as Iain said, very deep in the half year and the full year documents, we actually, since 2008, have made quite significant forward-looking projections around loss on that portfolio. And there's one very important accounting concept that the market needs to understand, is that those available-for-sale securities are provisioned on a fair value basis, not on an underlying cash loss basis. So you can have a security that you bought for 100 where the fair value is 70 and where you project forward your expected cash flows and you get to 99. So the accounting under IFRS delivers a 30 impairment charge, whereas you actually lose one on cash flows. So you'll expect to see some pull back over time as those fair value losses translate into realised cash flow losses and you get that unwind of that, in that example, 29. Which is what our half-year disclosures say.

James Chappell

So is it right to think that 18 billion provision over the last four years has effectively fed through the GBM provision line, or whether you are –

Russell Picot

No.

Iain Mackay

No, absolutely not.

Russell Picot

That's pure – that 18 billion was always a fair value adjustment – negative adjustment – to shareholders' equity only, and only a piece of it has ever been booked through the income –

Iain Mackay

Cash losses were predicted, I believe, in 2008 to be somewhere in the region of 800 million. Is that right?

Russell Picot

Yes.

Iain Mackay

And I think each quarter we reassess where the cash – the actual cash loss from those securities is derived and it has remained highly consistent with the guidance that was given in 2008.

Russell Picot

Yes. So at half year we said – the indication was further impairment charges 900; expected cash loss of 400.

And we also flagged the propensity of this book then to effectively release some of those loan loss provisions held for that fair value fall.

James Chappell

Okay, thank you. And just a final question. Have you seen any change in appetite for credit in the UK? Because you normally used to talk about overdraft utilisation…

Iain Mackay

A change? No, if you take that statistic, it has remained absolutely – well, not absolutely; it's moved a basis point or two, but it is stuck around 40% utilisation; it's slightly below 40. And that's business banking, so the SME – well, it's the small end of the SME sector and it's personal overdraft utilisation. So you go through… I mean Alan Keir in the Commercial Banking team uses that as one of the indicators of credit sentiment in the UK. Now, as you see in the UK we've continued to grow our net lending and our market share in mortgages and we've continued to grow our net lending in the SME sector, but with a very clear – now, it's not uniquely, but with a very clear focus on internationally-orientated SMEs in the UK. So the fund that we'd set aside for international SMEs of 4 billion we've increased to 5 billion and expect utilisation through the end of the year. So net lending for us in the UK is ahead of where we would have expected to be for the year and we're doing that, you know, at a level from a quality of credit and customer that we're very happy with.

James Chappell

Okay, thank you.

Shailesh Raikundlia, Banco Espírito Santo

Just one question. In the first half, you gave details about what your underlying return on risk-weighted assets was – about 1.8% – and you also gave details about, when you exclude the legacy and the CML portfolio, of about 2.3%. I think you indicated that – you indicated on the call that the drag from the legacy and the CML has reduced. I was just wondering whether you could quantify that. And also, I just wanted to confirm that the Q3 return on risk-weighted assets is around 1.7% this time round. So again, was most of the improvement through the improvement in the sort of legacy assets?

Iain Mackay

The underlying return on risk-weighted assets for the year to date was 1.7% and the year-to-date last year was 1.5%. Obviously the returns on the two elements that we adjust for is the legacy credit in Global Banking and Markets and the US CML book, so when you then adjust for legacy credit, at the year to date for 2012 the return on risk weighted assets was 2.2% and a year ago it was 2.4%. And clearly, the significant charges that we've taken for PPI and provisions in the US are going in to the return part of that equation, so they are part of underlying. We don't strip them out of underlying; those charges are part of underlying. And that is the main factor that's driving the deterioration in the year-to-date underlying, excluding legacy, return on risk-weighted assets.

Shailesh Raikundlia

I mean – being a bit cheeky, is there any indication of what the RWAs were in Q3 for the legacy and the CML portfolio?

Iain Mackay

Yeah. The risk-weighted assets at the end of the third quarter for CML was 125 billion and for legacy credit it was 46 billion, sitting in Global Banking and Markets.

Shailesh Raikundlia

Great; thank you.

Chintan Joshi, Nomura

Following up on PPI, you said – so you've got about 15 months of provisioning. If it think about your coverage ratio, so claims to provisions is about 50, but you haven't had 15 months historically of claims at these kinds of levels. So I'm just trying to understand that math there: how is it still 15 months of coverage? Because if you are roughly at 50% coverage ratio –

Iain Mackay

It's based on the expectation of change in the profile of the claims curve. So it's not based on 15 months of historical; it's based on 15 months with the expectation that claims will start to tail in November.

Chintan Joshi

But my point is future should be higher than historical.

Iain Mackay

Why?

Chintan Joshi

I mean you only started seeing very elevated claims over the last kind of five, six months; the level really stepped up.

Iain Mackay

Six months, yeah.

Chintan Joshi

And you are saying this should continue into Q1 next year, so we are expecting another six months of high and then a tail-off. So I'm just thinking the distribution is still higher going forward than what you've already had. Is that where I'm getting it wrong?

Iain Mackay

I'm not sure I'm following your question at all.

Chintan Joshi

Okay, I'll follow up later. On the impact –

Russell Picot

The provision is greater than the cash settlement we've had of claims.

Iain Mackay

Yeah, we've got $1 billion that has been disbursed and we've provided – what's the year to – what's the inception to date? 2.4 billion I think is the inception to date.

Russell Picot

2.1, I believe. 2.1 so far.

Iain Mackay

2.1, sorry.

Chintan Joshi

Yeah, it's 44%, not 50, sorry.

Iain Mackay

Yeah.

Chintan Joshi

On Apac, so – I mean in the third quarter you sure had an FX tailwind as well in Apac because Q3 FXs were better. I'm just trying to understand – over H1 there's a slowdown. Should we expect a slowdown because of the weakness in activities there before it picks up next year, or… What is happening there that causes the Q3 to be below H1?

Iain Mackay

Well, the growth is absolutely at a slower rate. I mean, you see –

Chintan Joshi

But there's still growth.

Iain Mackay

Again, I'm not sure you want to read too much into this. If you sit and look at what's happening in China next week, you've got the People's Congress meeting; you've got the beginning of the end of the transition process of the leadership in China, right? So normally you get the leadership announced probably the first week in December, so you get the Politburo, if you like, all laid out. You're beginning to see actions being taken by that leadership around some managed stimulation domestically, certainly, within China. I think our expectation is where mainland China sort of sneezes, Hong Kong instantly catches a cold, if not pneumonia, so the level of growth that you saw in Hong Kong over the course of the last six months has been very low.Low single-digit; in fact, even in cases, less than one. And our expectation is that you'll – if not the last quarter, which would be difficult, but certainly moving into 2013 we would expect to see some pick-up. Not – we're not going back to boom boom times, but we'd expect to see some pick-up, both in mainland China and in Hong Kong, and think that that will have some trickle-on effect to the remainder of the – to parts of the rest of Asia-Pacific. Okay?

Chintan Joshi

And finally just what's the FX headwind in Latam for the nine months to date?

Iain Mackay

So on a year-to-date basis…

Iain Mackay

Just – yeah, you see I've got the total underlying; I haven't split out FX. I've got total underlying but, as you know, underlying has got acquisitions and dispositions, and we've got acquisitions and dispositions all over the place. I haven't split out just the currency. That's 3Q to – so currency in Latam.

Russell Picot

So year-to-date –

Iain Mackay

Yeah, it's 217.

Russell Picot

Yeah, so there was a negative 217 on FX for Latin America.

Iain Mackay

On PBT, right?

Russell Picot

On PBT; that's right.

Chintan Joshi

And on revenues?

Iain Mackay

And Latam on revenues – hang on. It's 1 billion.

Russell Picot

So revenue is 1 billion. So to do the maths for you, 1 billion of revenues; just under 200 favourable on LICs and the rest is opex.

Guy Lewis

Okay, we've probably got time for one more decent-length question, so down to Patrick at the end of the…

Patrick Lee, Royal Bank of Canada

Just following on the FX situation, I mean does HSBC have any sort of hedging policy in place for the P&L over the equity base. That's the first one.

And for – the second one is regarding these held-for-sale loans in the US. Who are the end investors to these things usually? As in, are they hedge funds or investment banks buying them from you? And whether there's more appetite for it going forwards – is that a good way for to exit from the US loans?

Iain Mackay

Well I'll tell you they are not banks, okay? Certainly in the defaulted, they are loan management companies, of which there are a number which are recognised as both good managers of this kind of asset, in line with federal requirements around foreclosure management, and you have funds – not necessarily hedge funds – that look at – again, it's pricing against cash flow. So they're looking at current market pricing against their evaluation of ultimate cash flow realisation. And there are specialist investors across every state in the United States – they're small shops, generally speaking – that specialise in this kind of product. And for them, it's a simple arbitrage between fair market value accounting and their expectation of the cash flow pull-out. So the way this works is that you give them tapes that give a lot of operational data about the product; they model those tapes against their data and their experience; and they draw conclusions about what they can manage in terms of cash out of those portfolios and then it's a simple fair market value comparison and then the bid is structured around that.

Patrick Lee

And is their business model contingent on provision of credit?

Iain Mackay

It's contingent upon nothing as far as we're concerned; we will not finance this. They get it – you know, there are reps and warranties that you're selling – that you've disclosed all the right information so they've been able to do the right due diligence, but there is no financing provided with these transactions; none. This is servicing released, out the door, done.

Russell Picot

Clean de-recognition.

Patrick Lee

And in terms of FX hedging and –

Iain Mackay

We match FX from a structural perspective on the balance sheet. So assets, liabilities – mainly the net equity position is – the capital structure of that generally matches the foreign currency structure of the assets and liabilities in the Bank. So across each of our subsidiaries, the capital structure is there to hedge the currency structure of the assets and liabilities. So generally speaking we try and run a matched book. It's clearly not perfectly matched, so we do have structural FX positions, but generally it's matching the net equity position, okay?

Russell Picot

Just on P&L if I may, Iain, the Group's philosophy on not hedging P&L structural foreign currency exposure goes back 20 years. There was a lot of research done in the early 1990s and a lot of discussion amongst the institutional investor base and a very clear message emerged, which is that institutional investors wanted to actually buy the sort of currency exposure that you get with a company like HSBC and therefore if we actually spent money to go and hedge that back into US dollars, that wasn't something which was very commercially sensitive either for us or the market. So that is why we do not generally hedge P&L exposures.

Guy Lewis

Okay. With that, I think we will wrap up the meeting, so thank you very much.

Iain Mackay

Thank you everybody. Thank you very much.