Post Interim Results 2012 meeting with analysts

Questions & Answers
2 August 2012, 9:00 am BST

Iain Mackay, Group Finance Director, HSBC

Thanks for coming along this morning, I appreciate it. We still don't seem able to extend to a proper breakfast for you, but it's too late in the morning for a proper breakfast anyway. So no real introductory remarks here; I imagine that the vast majority of you will have listened in on the call and had the chance to go through the numbers, so rather than me wittering away, why don't we just open it up to questions and we'll take it from there? As Nick said, you need a microphone before you speak so that everybody can hear. So who wants to go first? Alastair?

Alastair Ryan, UBS

Thank you, yes. This is a bit peculiar having a microphone and sitting across the table from you.

Iain Mackay

I can hear you perfectly, Alastair.

Alastair Ryan

I'd just like to ask, since your investor day there were some fairly significant potential changes in UK regulation, and you touched on these a little on the call, but if you could elaborate a bit. So in particular liquidity – Funding for Lending, where HSBC is something of an outlier in having said it wasn't going to participate, and why that would be, because while your retail and commercial business in the UK is deposit-funded, your bank in the UK's not.

And on capital there was clearly pressure from regulators, which you talked about at the strategy day, for early adoption of Basel III and other banks and the regulators have said, subsequent to Mansion House, there is now no pressure for an early adoption of Basel III. What's your experience of that, and how does that drive your behaviour? Because clearly the Group's been very capital-generative in the first half and the run-off of legacy portfolios and retained profits means it's likely you'll be very capital-generative over the next several years, so, you know, transition periods would seem to be very relevant.

And then the level of confidence you've got about exemptions from PLAC and whatever, which are clearly Government intention but translating intention to policy can be complex.

Iain Mackay

And therein lies the issue. What was – so let me take your second point first, Alastair. The – what was said during the Mansion House speeches by both the Chancellor and the Governor were – I think all of us thought they were very encouraging. The fairest thing I can say would be to reference you to the minutes of the Financial Policy Committee. And in the Financial Policy Committee, the minutes are fairly clear that their expectation is that UK banks will continue to build capital, and the translation of what was said at the Mansion House into day-to-day supervision from the FSA simply has not occurred. I would go further to say there is no particular indication that it is likely to occur in the near future.

There are signs, however, that – and this is my interpretation, and this is based on very recent information, so the interpretation could be wrong – but my interpretation is that the communication with the FSA is that there is a realisation possibly dawning that building significant liquidity buffers and significant capital buffers at this time may not be the best thing to do for the economy. However, that has not resulted in the FSA saying, 'Right, we're going to cap – we're going to cut your capital planning requirements, and the buffers associated' with that or that 'We are going to provide some sort of specific relief on liquidity requirements' from an FSA perspective.

At the same time, however, they are very focused, for obvious reasons, on trying to make the FLS scheme successful, and they are trying to find ways to create capacity to support that, through some relief in liquidity but none obvious on capital. And the feedback of the banks to the FSA and the FPC has been quite unanimous in that the steps – the potential steps on liquidity, and those steps are really crystallising into something more than just potential, is really helpful, but whilst you to continue to push for capital growth in the UK banks, that is likely to be the main constraint, not liquidity, it's going to be the main constraint, so while you continue to pile on the capital requirements at the behest of the FPC, it is likely to be a headwind for the success of the FLS.

So we received a little bit of communication yesterday in this effect from the FSA. We're working through it but it wasn't particularly uplifting in terms of conveying what was said at the Mansion House into policy

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enactment. But you do get the sense – I get the sense that they recognise that some of the approaches now with respect to the extent of buffers maintained both with respect to liquidity capital are not going to be helpful in terms of trying to stimulate credit supply for the UK economy. But they haven't quite figured out how to moderate that at the moment. But there are, I would say, early indications of the desire to moderate, but they haven't figured out how to do so.

On our participation in FLS, we are – we think it's a good scheme. It's well-designed, we think. But in terms of the overall liquidity position of the UK bank just now, and the costs associated with that position, we don't feel the need to use it, and it's nothing more, nothing bad. We don't think it's a bad scheme; quite the contrary, we think it's actually a very good scheme. It's well-designed, it's pretty well thought out, but the success of it is going to depend on how they deal with policy matters in respect of liquidity management and capital management in the banks.

And I think what they do need is that for those banks that do avail themselves of those facilities is that they need to have some – and they are; they're developing that mechanism – developed it, I would argue; they need to see how it works in practice, but developing a mechanism to measure how much of that liquidity relief provided is actually funnelled through to the real economy. But our position from a UK bank perspective is our liquidity position is strong, the cost position is favourable compared to our peers in the UK and for the moment – we haven't said we won't use it, but for the moment, you know, it's a term facility that's going to be open for at least 18 months, and, you know, at some point in the next 18 months we may say, 'You know what? Not a bad idea.' But right now we don't feel the need or the desire. Nothing more sinister than that. Okay?

Tom Rayner, Exane BNP Paribas

Do I need to do the mic thing?

Iain Mackay

I'm afraid you do, because there are people on the phone that need to hear you.

Tom Rayner

Yes. It's Tom Rayner. Just following on, you think the FLS is a good scheme, you don't feel the need to use it. Do you – if you're Vince Cable, and maybe you're trying to score political points, maybe you're not, but if you're pushing towards sort of nationalising some domestic lenders because you think that none of these schemes are going to actually work – well, if you're Vince Cable, could you not interpret your comments as suggesting, 'Well, they're clearly not going to be trying to lend that aggressively, because it's so cheap if you do through the FLS, it would surely make sense to use it.' I mean, does that – I mean, I'm interested in your thoughts, actually, on this morning's story – I don't know if you saw around RBS and the discussions –

Iain Mackay

Yes, yes. First thing I read when I crawled out of bed.

Tom Rayner

Yes, I'm just – I'm interested in what HSBC's thinking is around that issue.

Iain Mackay

I'm sure Stephen liked it as well. The – I mean, if you look at what we're doing in the UK, we're growing our – we did it last year, we've done it the first six months of this year – we're growing our commercial lending into the SME sector, we're growing our mortgage book of business. There is absolutely no absence of effort from HSBC to support the SME sector and the residential property and personal lending in the UK. The growth that – you know, we've continued to build market share in new product; our market share over all has remained flat, half over half, but the amount – and it's included in the interim report within the European section, a regional review about how we've grown the UK business.

From a lending perspective we've got – I think it's a 4 billion facility specifically dedicated internationally, focused to SMEs. We've drawn down about 1.4 – or 1.4 has been drawn down against the facilities granted under that particular package. So if Cable takes that view with HSBC, we'll stick the facts in front of him and say, 'We are one of the few banks that is doing serious work to support the UK economy, which is a hell of a lot more than can be said for the UK Government right now.'

Tom Rayner

But do you think, though, that he then has a point regarding some of your competitors in the UK? I mean I think if I was RBS I'd say, 'Well, we're trying to do quite a lot as well.'

Iain Mackay

Unfortunately the data that's coming out of the Treasury doesn't really support that, right? If you looked at the data for the full year last year, net lending into the SME sector contracted by – I think it was 2%, whereas we grew ours by 4%, so –

Michael Helsby, Merrill Lynch

Is that a redemption issue, then? Because clearly your market share, your gross – you've got a big market share and you get redemptions –

Iain Mackay

Our net new lending was up. Net new lending was up. You make a great point. Again, it would be really good in the present climate if we used the facts – and there are facts available, I think, to support what the Government's trying to do. It's just the schemes that are being used to do it may not be as successful as they could otherwise be without a good look at both micro and macro prudential measures being taken by – so there's this, and I think I'm quite optimistic about seeing this coming together progressively over the next couple of years under the Bank of England.

There are very good, smart people who are being charged with trying to pull this thing together, and my belief is that progressively we'll get the right balance of policy with respect to economic stimulus, balanced with the right financial policy about micro/macro prudential supervision and regulation, but we're not quite there yet. But I'm reasonably optimistic we can get there.

I think the challenge that Andrew and others in the FSA face is that they've got to take the FSA, they've got to split it in two, they've got to continue an effort of significant supervision of the financial services sector in the UK, they've got to retain staff who are probably becoming as disillusioned as staff in the wider financial services sector, and implement very significant policy changes at the same time. So they've got a very significant undertaking, and I think the question that we ask ourselves is – I think they've got good leadership around this, but do they have the right sort of operational capability and the right number and quality of people in place to pull off what they need to pull off? But I'm reasonably optimistic. It's just not quite coming through from a policy perspective into practice. Michael?

Michael Helsby, Merrill Lynch

Michael Helsby from Merrill Lynch. I've got a few questions; I'll just do one at a time. I think what you've done in terms of trying to remove the risk-weighted assets of the legacy businesses and looking at the returns clearly has got a lot of merit, and that's very helpful. I think from a – to look at both sides though, it'd be really helpful if we could have a view on what you think the expected loss or the friction cost or the overall losses of that run-off or removing those risk-weighted assets would be. I'm sure you've modelled that, and I was just wondering if there's anything you could do to share that view, and as a supplementary to that I guess I noticed in your HFC accounts that there was a £1.5 billion charge in the P&L as you moved a portfolio to held for sale –

Iain Mackay

Held for sale, yes.

Michael Helsby

I know that's not in the Group accounts because the treatment's different –

Iain Mackay

US GAAP versus IFRS.

Michael Helsby

What circumstance would that actually get recognised? Is it when it finally gets sold, or can it come in before that?

Iain Mackay

It's a good catch, actually, Michael, and it relates specifically to your first question. We've disclosed again – we disclosed at the end of the year what the theoretical mark to market is in the CML book. It's about £12 billion. It's between £12-14 billion. The accounting item that you referred to, the charge on the transfer to held for sale under US GAAP accounting in the US financials, is reflective of the fact that we have two transactions that we're working on.

We have two fairly sizeable tranches of the CML portfolio that – and you'll recall that we mentioned at strategy day and again at the end of the year that we were working with BlackRock to do a detailed operational analysis on our CML portfolio, to make the business much more capable of responding quickly to bid opportunities in the marketplace around exposing those assets. We as a result – partly as a result of that work, we've got two reasonably good-sized transactions that the team is active on, that we are hoping – and again this is all about market forces, very little to do with structure and everything to do with the longer-term view of the recovery of the US residential property market. But we've got two transactions that we'd be hopeful that we can get traction on between really the fourth quarter or first quarter of next year, which if successful would be a significant step forward in terms of reducing the size of this book.

Where we stand overall is that we clearly carry very significant surplus capital in the US. We clearly have a drag from a profitability perspective coming through the CML book, and we have a pretty clear picture of what the economics are, both in terms of NPV, impact on

PBT, and, more positively, impact on ROE by finding the right balance.

Michael Helsby

By making the E go down.

Iain Mackay

Part of it is E going down, right? If we're going to get this book off quickly, equity is going to be consumed. It's striking the right balance between how much we're prepared to let go, so there's focused work in that regard.

Michael Helsby

Just on – if – I guess because the – it feels like the old household book, certainly the Q on Q bad debt charge fell, NPLs have kind of been broadly static, but there's a lot of loan modifications –

Iain Mackay

Two-plus delinquencies are coming down.

Michael Helsby

Yes, and then historically the potential, if you like, for people who have been modified to then go delinquent eventually and go bust has been quite high. So how do we think, or how should we think, about that bad debt charge? I know clearly it's a steady-state economic view that you need to take, but from a provisioning – how should we think about that? Should we just think about it steadily drifting down, or is it stubbornly high, or, you know, for – you know, for a place to say, the US housing market stays moribund where it is?

Iain Mackay

Your last comment sort of captures everything, right? The US housing market is showing very little sign of recovery and there's really very little from a policy perspective, and you can completely understand why from a political construct, but there's very little sign of any policy action to aid the recovery of the housing market. There's a bubble of 180-day-plus past due accounts sitting across the industry. From certainly our standpoint, at the point of 180 days past due, we partly charge off that book. We call it partly charged off, because we take the difference between the expected cash realised from the disposition, the eventual disposition of the property, less the cost to dispose that property, against the original or the remaining unpaid principal balance, and that charge goes to the P&L.

However, that sits as an impaired reservable – so it's already been reserved, if you like – on the book until we can foreclose on the property. Once foreclosed the property is actually working through our real estate owned portfolio at pretty much the same pace as it has for the last four or five years, so round about 180 days. Our current loan population assumes we have 26-27 more months on average before foreclosure will be completed and the underlying property sold. So it went up a little bit, it's back down a little bit, but you'll also see that our inventory of foreclosed properties has come down fairly significantly, because, although we're doing foreclosures in all but two states now, the rate at which we're doing them is incredibly slow, because the rate at which the state will allow those to move is incredibly slow.

And that's an increased level of supervision of the foreclosure process, which is in line with the consent – cease and desist orders that were issued to various banks – the vast majority of banks – over two years ago; and the second aspect is that it's a political one. People don't want – understandably, politicians don't want people being put out of their homes during the presidential election year.

So in terms of working through that bubble in the US property market, I don't see anything – nothing's going to happen from a policy perspective until the middle of next year, and therefore it's going to feel pretty moribund. And therefore from an impairment charge perspective, we always get seasonality in the third quarter; it would be a pleasant surprise if we didn't in the third and fourth quarter of this year. That being said, right through to the payment cycle on 25 July, numbers were holding up pretty well and certainly were better than they were at this time last year. But I would expect the loan impairment charge to tick up ever so slightly – well, this is wishful thinking – I would expect it to tick up a bit in the third quarter, flatten out in the fourth, and then I would expect it to come down again in the first and second of next year.

But the rate at which that charge has come down, given that the book is going to shrink, both through continued charge-off, which, you know, all the book that writes – principal that disappears from this book, about 44% then gets charged off, the rest of it's collected out. But I think the step function reduction in this is us being able to accelerate the runoff through dispositions. But I think the rate at which we've seen loan impairment charges come down over the last two years, I would expect that rate of decline to slow somewhat.

Michael Helsby

Thanks, that's very helpful. So, just to be clear, on these two transactions that you're working on, from an IFRS perspective, should I think of that as being, it's – if that actually happens, so that fair value decline was

recognised, is it on the actual transaction that it would be booked through the IFRS accounts, or is it at a date before that?

Iain Mackay

We would need to get much closer to the probability of the transaction before it would get booked in to held for sale for IFRS.

Gavin Francis, Deputy Group Chief Accounting Officer
But it's likely to be on the transaction because it's financial assets and liabilities. So it's a difference in US GAAP.

Michael Helsby

Okay, thank you.

Tom Rayner

So 12-14 is on the whole book; it's not on the transactions?

Iain Mackay

No, no, it's the whole book. Thank you for that clarification. Right. Yes?

Rohith Chandra-Rajan, Barclays Capital

Sticking on the same subject really, in terms of the sort of capital position in the US, just thinking about capital repatriation or usage, which you just talked about, can I ask what the Core Tier 1 level is in the US? And then do you need regulatory approval in order to execute on the disposal that you've just talked about?

Iain Mackay

It's a great question. If you look at the US bank financials, there's two different metrics in the US. In the finance company it's a tangible equity to tangible managed assets ratio that we maintain – that we've agreed with the Fed years ago, and we maintain that between 6.75-7.25 and have always maintained that in or slightly above that range – so it's a technical ratio that we use for the Finance Company. In the US bank, the Tier 1 capital to risk-weighted assets is 14.3% for HUSI, so the holding company of the US bank, and the common equity is basically 12%, okay? But they're US GAAP measures you're getting there.
Rohith Chandra-Rajan Okay, thanks. And do you need regulatory approval for those deals?

Iain Mackay

To do those – to do the disposition, I do not believe so. To repatriate capital, do dividends, absolutely.

Rohith Chandra-Rajan And then just on that repatriation, which you've talked about as being a sort of 18–24 month timeline, what do you think needs to happen? What do you need to do in order to execute in that timeline, and does the sort of money laundering issue colour that or delay it at all?

Iain Mackay

There is a long and distinguished list of things we need to do, and I think as we talked about at the strategy day at the end of the year, the OFAC Sanctions, the Bank Secrecy Act, anti–money laundering are absolutely considerations on the part of the OCC and the Federal Reserve – principally the OCC – which would influence their willingness to allow us to move dividends from the US bank or the Finance Company and their holding company up to the Group.

So we have to demonstrate the sustainability of the changes that we have implemented and are implementing with respect to OFAC sanctions and anti-money laundering. We have to demonstrate through our capital planning and then the performance of the US businesses, particularly the US bank, a level of sustainable profitability within that business, and we have to, I think, convince the regulator that we absolutely have a handle on the run-off portfolio that remains within the Finance Company.

Now I think that of the things – of that short list, the final item, the business has made progressive and consistent progress over the last few years on that front. And in actual fact, when you look at what the Federal Reserve regulates us on now, there is very little, because the Fed is the regulator of the bank holding company; they are not the regulator of the bank in New York. That is a national bank and it's regulated by the OCC. What the Fed basically regulates in the US now is the CML portfolio, plus the capital of the holding company in the US. So the sort of things that the Fed can exercise their work on a daily basis is becoming a pretty short portfolio of work, but I think it's reasonable to assume that they'll tackle that rather short portfolio of work with great enthusiasm and gusto.

But, you know, if I was sitting in their shoes, I wouldn't let a penny of capital out of the US until we've satisfied them that we've got our act together in the US with respect to anti-money laundering and sanctions. And there has been, you know, the better part of two years' worth of work done, led by Irene Dorner in the US, to get that shipshape. So there's real progress being made, but there's more to do.
Rohith Chandra-Rajan Thanks.

Chirantan Barua, Sanford Bernstein

This is Chira from Sanford Bernstein. Just a quick one on the US. Where are you deploying your excess capital right now? Are there any areas, be it in the transaction bank or be it –

Iain Mackay

It tends to sit in US treasuries, so what we are using within the business is to grow the commercial banking business, and that's been very successful over the last 12 months. That part of the strategy is making very good progress, which we're happy with, but otherwise it's sitting in balance sheet management. The Federal Reserve's getting a lot of money from us just now.
?

James Chapell, Berenberg

This is James Chapell from Berenberg. I have a number of questions. Just to go back to something you were talking about earlier, and particularly in the UK, everything you've discussed was kind of supply-side reforms. Is there actually any credit demand in the UK? I mean you can see the international business for you guys to benefit, but is there actually any demand?

Iain Mackay

Based on our portfolio, the overdraft facilities that we've got out there, the utilisation is declining. We're sitting around 40% utilisation. At the end of last year we were around 40%; at the end of the year before we were around 42%. So the utilisation of existing or committed overdraft facilities is – it's not moving up.

James Chapell

The second question was just on global markets income. How much of global markets income is derivatives-related?

Iain Mackay

Very little. If you look at the businesses that grew within the global banking and markets business – I'm sure there's something in the book in here on that one actually – it's in the back – I think it's on page 27 of the slide pack, you know, where you see the revenues. Now you clearly saw an expansion of the rates revenue in the first quarter of this year. That held up reasonably well in the second quarter, but that was driven very much by spread tightening within the eurozone area. But the other areas where you've seen the pickup is foreign exchange, which is straight customer flow. The volumes are up, there's a little bit more volatility in the space. So the trading income's a little bit better, but it's very much driven by flow business through the commercial bank and global banking business.

Balance sheet management was up considerably as well. That was driven by a bit of repositioning within the book; there were quite a lot of available for sale securities sold – again, we made about a £400 million gain on available for sale securities in the first quarter, a couple of hundred million in the second quarter. Payments and cash management, again, not a derivatives business; that has been driven by market share pickup, particularly in Asia, a little bit in Europe, a little bit in the United States and a good – a really good progression in Latin America, actually.

Those are the main drivers, and you can see certainly from a credit perspective the revenues have been, you know, pretty stable through the piece. Certainly, you know, the first quarter was fairly robust, but otherwise, you know, pretty stable. From an equities perspective, volumes are down; Securities Services is pretty flat – that's kind of a flow business for us – Assets and Structured Finance pretty flat; that's very much customer-driven business, very little of it from a derivatives trading standpoint. So this is customer flow and very little of this is coming out of derivatives trading.

Chintan Joshi, Nomura

Hi. Chintan Joshi from Nomura. I just have a number of little follow-ups – or not so little. The first one on the FLS you discussed. I'm wondering if there's a risk that banks if they do not lend to the economy, and the FSA, rather than thinking about moderating capital requirements, think about forcing capital into the banks. How do you view that risk, and is that something that has been discussed, or have you heard anything around that?

Iain Mackay

So the view expressed by the Financial Policy Committee for – no, let me put that differently, to be careful. The view expressed by certain members of the Financial Policy Committee is that they believe that they can have the banks support stimulus in the economy by relaxing liquidity requirements whilst continuing to reinforce capital requirements. They believe banks are capable of reinforcing their capital by cutting the variable compensation of their employees, by restricting dividends to their shareholders, and by raising capital in the marketplace. Funnily enough, generating profits doesn't seem to figure in their calculations.

As was pointed out to them by one or two in a recent meeting, there are very few UK banks actually paying dividends. If you take the total – and we disclosed this information last year – the total variable compensation bill for the UK businesses in HSBC was $900 million. You'd have to leverage up that an awful lot to have any significant impact in terms of stimulus to the UK economy, and certainly from Stuart's and my perspective, we will fight to the death if they go after our dividends. That is not on. If you expect to be able to raise capital in the marketplace at any point, you've got to remunerate your shareholders. So from our standpoint pretty much everything else will go before the dividend.

But, you know, there is this view that the shareholder doesn't matter, and we find that more than a little bit worrying. I'm not quite sure how they would force capital into the banks. Unless it's coming from government coffers, you know, there's already legislation out there in Europe which will have a fairly dramatic effect on compensation levels, conceivably, although God knows there are more ways that you could engineer your way around that one, but it wouldn't do the industry's reputation any good to do that. It certainly wouldn't be the desired policy outcome.

Again, the alignment around financial conduct, the Financial Conduct Authority and conduct regulation, with prudential regulation, there's a gap missing there. You know, the banks are busy – now, for good reason in many instances, but not across the board. But UK profits are being disgorged on things like PPI and potentially on interest rates, and potentially on other matters which the Financial Conduct Authority is going to spend a good deal of time looking at. And where mis–selling has occurred, it's absolutely appropriate and redress should be provided, but across the board, basically saying, 'PPI is a bad product. Interest rate swaps or caps are bad products' is not the way to do it, and that is approach that the FSA has taken so far. But mis-selling of PPI doesn't make PPI per se a bad product.

Chintan Joshi

While we're on that topic, could you just give us the split of the PPI and the –

Iain Mackay

Oh, Chintan, you fell for that one so badly. Sorry, what was your question?

Chintan Joshi

The split between PPI and interest rate swaps of the 1.3 billion.

Iain Mackay

Yeah. 1.1 billion of it is – just over a billion of it is PPI and most of the rest of the balance is interest rates, and there are one or two other items. So we had NHFA at the end of the year; there's a little bit in there for NHFA and a couple of other things, but it's basically a billion to PPI and the rest to interest rate protection products.

Chintan Joshi

Any comments on LIBOR?

Iain Mackay

No, there's not – I mean the disclosures within note 25 are absolutely it. We're not trying to be cute here. We are on lots of rate-setting panels; the regulators that are now looking at overseeing those panels have asked us to provide information, and we are providing information, and that's as far as it goes. So, you know, we're not being investigated. That doesn't mean we won't be in the future, but we are providing lots of information. We're being extremely cooperative. But again, if you think about the structure of our balance sheet, in the vast majority of our businesses around the world we are deposit-funded, and, you know, from our standpoint more often than not the submissions that we've got going in are getting kicked out of the equation. But how LIBOR's set doesn't matter: it's the underlying behaviour, and we are supporting the inquiries, absolutely, and providing all the information that's been requested of us, very willingly.

Chintan Joshi

One UK bank thinks that they should speed up ring-fencing; another hasn't started thinking about it. Where are you in this picture in terms of execution of ring-fencing, and do you think there is competitive edge to be had if you speed up ring-fencing?

Iain Mackay

Yes, but like CRD4 ring-fencing, there's not much definition to it right now. The fairest thing to say is that we simply don't think this will have the desired effect. The universal banking model works. It's not – again, what are we trying to solve here? Ring-fencing doesn't solve Northern Rock. Ring-fencing does not solve Lehman Brothers. It doesn't solve Bank of Scotland. Well, maybe. Well, no, it doesn't solve Bank of Scotland. It might have solved Royal Bank of Scotland, but I very much doubt it, because what caused the failure of Bank of Scotland had nothing to do with ring-fences or lack of ring-fences or what was going on in the investment bank. So what's the problem we're trying to solve?

So we will absolutely stick to the position that we do not think it will solve anything, but at the same time we fully recognise that there is almost certainly going to be a ring-fence of some size, shape or form, but we see no advantage at all of moving towards a definition of a ring-fence by ourselves, when from our perspective we would like to put as much inside that ring-fence as we possibly can. And the degree to which there is definition around this at the moment, or lack of definition around this, doesn't help that debate.

But when you look at other banking models in the UK you can see why people would go, 'You know what? 90% of my business is going to be inside the ring-fence anyway, so let's get on with it and take it off the table and move on.' It's not the case for us.

Chris Wheeler, Mediobanca

Yes, hi. Chris Wheeler of Mediobanca. Three questions, I think. One just a follow-up there. I mean, in terms of ring-fencing, given your Scottish antecedents as a bank and your personal Scottish antecedents, I mean, is part of the ring–fencing game quite the opposite sort of line to Basel III – like, 'Why should we spend the money now when we can spend it in three years' time?' And I know we don't have clarity, but is that part also of your thinking in terms of how you deal with this? Because it is going to be very expensive, obviously.

Iain Mackay

To ring–fence?

Chris Wheeler

Yeah.

Iain Mackay

Yeah, probably.

Chris Wheeler

New Boards of Directors, Audit Committees, no tax looping: all this kind of stuff that you have to deal with is not going to come cheap.

Iain Mackay

Yes. Yes.

Chris Wheeler

So why spend the money early, in your case?

Iain Mackay

Well, you know, it's a bit like putting an order down for a new Jag F-Type, right? Until you know what it is –

Chris Wheeler

I wouldn't know; we work in financial services.

[Laughter]

Iain Mackay

I'm not saying anything. But why would you put the deposit down until you know what the thing looks like, right?

Chris Wheeler

Good point.

Iain Mackay

It's not – I mean we've done an – we've done a lot of work internally around modelling; you know, 'You draw the line here, you draw the line there, what does it look like?' But the fact of the matter is, none of them really work, right? So you're going to duplicate balance sheet management, probably. We've already got a UK Board, so that's not a duplication from our standpoint. We already – there are things that will be less expensive for us because of the existing corporate structure of the Group. But nonetheless there will clearly be corporate restructuring that will be necessary, and there is an expense associated with that.

The work that we are really focused on is much longer-term structural work around how we accommodate the global markets – global banking, global markets, and come up with a consistent business model that we then think would fit into an appropriately and securely structured – a corporate structure that regulators would look at and go, 'That makes sense to us.' There's part of me that thinks that we're more likely to end up with something that looks a bit more like the Dodd-Frank Act and the Volcker Rule, as opposed to necessarily a full ring-fencing. But, you know, there's a long way to go in this debate yet. But yes, and being a Scot with many antecedents, I don't like spending money until I have to.

Chris Wheeler

Okay. It's a good question. I asked the other day about the work you're doing in retail banking and wealth management, and I think you said you were 60-70% done. Some life deals you want to get done, but in terms of timing and obviously getting the business back to focusing on, you know, running the business, is that to do within a sort of full year timeframe you laid out last year at the investor day? Is that when you were looking to sort of get to the 95%, given that you'll never get to 100%?

Iain Mackay

Absolutely, in terms of the restructuring and getting the business model, absolutely. In terms of accomplishing the longer term targets around the 4 billion in wealth management, that's a longer term prospect, as Paul said at the strategy day. But from a structuring perspective, to be clear, you know, the team in the UK, the team in Hong Kong, the team in Singapore that run the retail bank wealth management, are focused on running retail bank wealth management. The restructuring that is being done is being driven by John Flint and the team here in London. It clearly requires a lot of help and resources from the teams on the ground, but we're trying to keep a level of – you know, those priority markets for us, which we've identified, it is, you know, let's get on with the business of building retail bank wealth management, whilst recognising that we've got business model simplification, product rationalisation, customer segmentation to do, that's what their focus is; whilst we've obviously got a team centrally that's much more focused on the actual restructuring of the Group.

Chris Wheeler

Just a final question, really on the dreaded subject of the money laundering issues that you're having to deal with. Couple of points there – you mentioned about sixth filter, but who are you actually having to go through this debate with? Is it the US authorities? Is it the broader regulatory authorities both in the US and in the UK? And then the point that really sort of struck me is, you put this, you know, obviously stronger compliance in place, and how it works into the business. But obviously at the same time you're cutting a lot of layers out of the business, which we all applaud. But from the regulator's perspective may look a little weird, in that here are these guys telling us they're being much more cautious and yet they're cutting out a lot of layers that they had before, which may appear to be actually making the business perhaps less able to pick these things up. I mean, first of all, who are you dealing with on this, and do you have any issues around the changes you're making, however welcome they are to the market?

Iain Mackay

So on change, the regulators have taken a great deal of interest in this. In particular, the HKMA were probably the first to say, 'Hang on a second, we really want them to pay some attention to this,' probably because it was the Hong Kong business that drove a lot of this restructuring earliest on in the process, and through the work of Peter Wong and Sarah, and the rest of the team in Hong Kong. I think they've very much got to the point of satisfying the HKMA that we've done this restructuring without having any adverse impact on the control capability – in fact, the contrary, in terms of getting greater clarity around roles, lines of accountability, roles and responsibilities, to the point that we're not – you know, there is real accountability around whether it's financial accounting and reporting, whether it's the varied and many aspects of compliance, whether it's risk management, and quite the contrary, we don't see this weakening the organisation. We see it strengthening the organisation, principally through better alignments around roles, responsibilities and lines of accountability. But I think we've been – well, I meet with the HKMA every time I go to Hong Kong, and, you know, they keep a very close eye on this. But I think we have very much satisfied them that what we're doing is sensible, and it's moving us in the right direction.

Chris Wheeler

Are you dealing with the UK and the US at the same time? Or is it mainly the HKMA?

Iain Mackay

The FSA's interested in this, the Fed's interested in this, but you know thus far we've had the same outcome.

Chris Wheeler

Okay.

Iain Mackay

Alastair?

Alastair Ryan

Sort of from the sublime to the ridiculous, Hang Seng – and it's a new accounting – is likely to move its accounting of Industrial Bank from an associate to –

Iain Mackay

An investment.

Alastair Ryan

And it seems the trigger for that was this sort of rights issue that was done without them being asked, more or less, by the Chinese, so whether there's any read-through to the much more important stakes that the Group has more broadly, and then just, you know, give an update on how those relationships work. Because from the outside they are – they're a peculiar thing, right? I mean, they've been very successful investments, but it wouldn't seem obvious that you were in the driving seat of what happens.

Iain Mackay

Funny beasts, right?

Alastair Ryan

Yes.

Iain Mackay

As you can tell by our actions, the Industrial Bank investment has been a good investment, but in terms of where Industrial Bank's going, we viewed it as being less strategic, so the accounting is likely to move on that to reflect that and also to reflect, you know, the role that we play on the board there. With respect to, you know, BoCom and Ping An, the relationships continue to be very, very strong relationships, with very much, you know, the level of collaboration and cooperation, notwithstanding the fact we're minority a shareholder, so we do not run operations or have any real significant influence other than through the board in BoCom. You know, that's a business that we like; it is banking, and it's going well, and we'll continue to, as you've seen us, take up our rights and maintain our share, and were the opportunity to come up, grow our share within BoCom. Within Ping An it's been a great investment. It continues to be a good investment. Our relationship with Peter Ma, and again through a number of representatives on the board of directors, continues to develop along quite nicely. Now Ping An has clearly got growing interests in the banking sector, and that has some adverse effects in terms of our regulatory accounting, around risk-weighted assets. But again, it's a great investment. But the action that you've seen in Industrial Bank is a reasonable reflection of our intention with respect to Industrial Bank. I wouldn't read that across to the other two.

Tom Rayner

Yes, thank you, this is Tom Rayner again at Exane. Just ask, on disclosure, I mean, obviously it's an increasing focus of HSBC to look at the product lines rather than the geographies. We're also now seeing more notable items disclosed, and adjustments made for these, and it seems at the moment the disclosure is such that it's quite hard to sort of reconcile these back to the product groups, rather than just the geographies. And I just wonder if the sort of additional disclosures you gave, whether we could start to address that, so you can get a better sense of what the different divisions are doing on a proper underlying basis, rather than just the geographies now.

Iain Mackay

That's a good point. It's a good point. Yes, no, I mean, clearly when you look at things like PPI, it's all hitting retail banking and wealth management for the vast majority, all right? If you think about the interest rate, there's a bit of a split there between global banking and markets, and commercial banking, and very little influence on the retail banking wealth management. That's an interesting point; we'll reflect on that.

Alastair Ryan

You realise you have just written off somebody's year there?

Iain Mackay

No, no, no, no.

John Caparusso, Standard Chartered Bank

Yes, Ian, thanks for taking the call. I just have a couple more questions on the CML portfolio. First, just very quickly, you've given us the loans outstanding in that portfolio but not the total assets, and I'm just wondering if you are at liberty to disclose that. At the end of 2011 you –

Iain Mackay

On the first point, if you pull down the HBIO 10-Q from the website, that'll give you the whole balance sheet of the finance company.

John Caparusso

Okay, great, thanks. And just going forward, I'm interested in the ratio between the sort of risk-weighted assets to assets. At the end of last year it was around three times. Do you expect that to evolve as you go into, you know, Basel 2.5 and then Basel III?

Iain Mackay

On a proportional basis, I don't believe so.

John Caparusso

Okay, great, that's helpful. And then on the US mortgages, your disclosure talked about the impairment charges related to the delay in cashflows from the mortgages, and there was also some discussion of erosion in the underlying property market conditions. I'm just wondering if you've got any kind of disclosure on how much of the change in your loan impairment was due to the change in assumptions versus the actual underlying conditions.

Iain Mackay

The specific disclosures around how that reserve is built is, if you go into the interim report under personal lending, and our US personal lending and US mortgages, it will give you a fairly detailed view of how the impairment charge is influenced by different factors in the US. The most significant factor is two-plus delinquencies. Probably the second most significant

factor is the cashflow discounting based on the delays in receipt of those cashflows over an extended foreclosure timeline. And somewhere down the list, the effect of the property value movement overall is probably fourth or fifth in terms of influence, for the simple fact that property prices have been – probably a little bit overly optimistic to say that they've thoroughly bottomed. But the impact in terms of further declines in the markets that we serve on residential property have, you know, it's pretty flat. It's very, very small movements in that regard. There's certainly no uptick, but the downward movement's pretty light as well.

John Caparusso

Okay, that's very helpful. Just finally and quickly on the AFS securities disposal – it looked like that was about £500 million higher in the first half than in recent halves. Just wondering if that's a one-time blip, and if we should expect that to go down by about £500 million going forward.

Iain Mackay

That was repositioning within balance sheet management; the vast majority of that appeared within the first quarter. There was – I think a reasonably normalised level of activity would be that represented by the second quarter.

John Caparusso

Okay, excellent. Thanks very much

Fred Thomasen, Goldman Sachs

It's Fred Thomasen, from Goldman Sachs. I just have a couple of follow-up questions on the assets that have been reclassified as held for sale in HFC. So the first one was, could you talk to the associated risk-weighted assets? It looks like about 15% of the portfolio, where I guess the total risk-weighted assets is something between 123 – or $122-123 billion but there's also a skew to 180-day overdues in the portfolio that you reclassified, which is probably a higher risk weighting, so could you talk to the risk-weighted assets that sit in the held for sale portfolio?

Iain Mackay

What sits in there is a mixture of non-real estate, and real estate 180 day past due.
Fred Thomasen But is there a number you could disclose for the total risk-weighted assets attached to the 6.8 billion of receivables that you reclassified? Because I guess on an average risk weighting it's almost 20 billion of risk-weighted assets.

Iain Mackay

There is not a particularly distinguished difference between what's been reclassed, and what remains within the portfolio.
Fred Thomasen Okay, that's helpful.

Iain Mackay

It's reasonably representative of the book as a whole.

Fred Tomlinson

Very good. Okay, and the second question was just on the second half adverse seasonality in credit trends that you discussed for the portfolio. Do you expect that to be impacted, I guess, on a US GAAP basis by the reclassification? Because as part of it you've taken some quite substantial fair value marks, which presumably frontload your impairment in that –

Iain Mackay

For US GAAP yes, for IFRS, no.

Fred Tomlinson

Okay, perfect, thank you.

Sally Ng, CICC

Hi, thanks Iain. Just a quick question. I noticed your peripheral eurozone exposures increased to 37 billion net. We've seen further increases mainly from Spain and Ireland on the off-balance sheet commitment, so just wondering what that is about and if so, regarding the redenomination, with potentially one of the countries exiting the euro, is it possible to draw any similarity in terms of the loss experience between for example, Greece and Indonesia, Thailand and Korea during the Asian financial crisis? Is there any similarity of experience that we could draw on that?

Iain Mackay

I think as it relates to redenomination, this is an aspect of disclosure that the FSA specifically wanted us to provide. I think it's a perfectly sensible set of disclosures, but it is our assessment of really how that risk, or the manifestation of that risk, might be played out, and the possible impact of it. But it is somewhat hypothetical in nature, and what clearly informs our assessment of that is the experience of the past. But what informs it above all is just a construction of the book that exists within those countries that might be viewed as more susceptible to redenomination risk, and you can certainly pick on poor old Greece again as being one of those possibilities. But it is, again, that the work we've done, you know, really over the last 12 months, in terms of trying to ensure that we've got the

right balance between assets and liabilities denominated in the same currencies sitting within those balance sheets, you know, is reflected in the disclosures that we've provided here. So there was a position which was different six months ago, and through repositioning both assets and liabilities, I think we've got a better match, and have mitigated some of the redenomination risks. So it's by no means a risk that we've been asleep to, certainly for the last 12 or 18 months, but particularly over last six months did some very concerted work to ensure that we mitigated some of the risk in that regard. But it wasn't particularly informed by what we'd experienced, you know, in Argentina, for example, in 2000. Sorry, your first question on exposures – you'd included Ireland there or something, was that it?

Sally Ng

Yeah, the off-balance sheet commitments for Spain and Ireland went up half and half. So I was just wondering what that might relate to.

Iain Mackay

That's a good question actually. I don't have specific details on that. We'll follow up and we'll get back to you, okay?

Sally Ng

Okay, thank you.

Sandy Chen, Cenkos

Sandy Chen, from Cenkos. You'd probably accuse me of trying to get you to do some of my work, and being a bit of a doom-monger, but the exposures in – I guess I was looking at macro read-across from, if there's potential deterioration in France, in particular, and as well the US fiscal cliff effect. I mean, what are your basic assumptions, I guess, you know macro, on both of those? And if, say, you know, the fiscal balance in France deteriorated significantly, and there was significant spread widening, you know, could you give a kind of range of potential effects that you would have to look at?

Iain Mackay

Well, let's be clear. We've got important businesses in both France and the US, so this isn't us just lending into these economies. We've got big businesses with lots of employees, with substantial balance sheets. So we're running those businesses, you know, fully cognisant of the economies in which we're operating, and position them accordingly. So we're not, you know, we're not about to go into some mode of significantly disposing more French or US businesses, other than those that we've already disposed within the US. But through the positioning of the balance sheet in terms of appetite to take on particular types of risk, it's remarkable, again looking at the numbers here, about how we've reduced certainly interbank exposures, exposures to governments, government agencies across any number of countries in the eurozone. However, in terms of maintaining fairly substantial balances with the European Central Bank through our French business, with significant balances with the Fed through our US business and others, you know, it's a reflection of our risk appetite, but I wouldn't, you know, certainly, read too much into it other than the fact that we're very conscious of managing what we see as risks out there in the economies in which we've got big businesses.

Sandy Chen

All right, and I guess just to ask a bit deeper – in terms of any eurozone debt securities exposures from the sovereign, is there a lumpy exposure potentially to the French sovereign, on a spread widening risk?

Iain Mackay

No. I mean, again across the whole of Europe, we've de-risked the balance sheet significantly. But clearly the risk sitting in France and Germany, because we've got substantial businesses there, where you'd expect, you know, to experience significant cliff effect items with a, you know, complete wind-down of Europe, which we do not – you know, it's not our base case at all. Then, yeah, there would be significant challenges in those businesses.

Ian Gordon, Investec

Hi, it's Ian Gordon at Investec. At previous sessions such as these you've taken the opportunity to slightly dampen expectations for the pace of loan growth in Hong Kong and Asia. Could I invite you to just provide some general comments on the outlook, and perhaps if you could just link that back to the so-called trapped capital debate, which we touched on earlier? Given my views on the outlook for Asian growth, and the consensus views and your rate of internal capital generation, I – point taken about dampening effects on group ROEs but I really struggle to see that the trapped capital debate provides any constraint on your ability to grow assets within obtainable scales. I'd appreciate your views on that.

Iain Mackay

Not in Asia. The business in Asia is well capitalised. You know, self-capitalising, significant dividends coming up to the parent company, we've clearly seen slower growth in the first half as we did in the second half of last year. I think Stuart was fairly clear in the

call about our expectations for growth – they're going to be running at slower rates, but that said there's still growth there. There is absolutely still growth, at least for the moment. You know, the knock-on effect of both the US and the European economies is clear in China, and what's clear in China then filters through to other economies in Asia. But you know, again we saw robust revenue growth in China, in Singapore, in Malaysia, in Indonesia over the course of the first half. So the growth opportunities are still out there, but there's no doubt about it; they're more muted than they were six months ago. And we would expect it to remain fairly muted for the foreseeable future. But there's still growth there.

Ian Gordon

And the same for Hong Kong, broadly?

Iain Mackay

Yeah, I mean, you know, the economic – the GDP in Hong Kong was 0.4% for the first six months of this year. We grew the book a little bit ahead of that, and we grew our revenues considerably ahead of that, admittedly off fairly robust lending in the first half of 2011. But the growth that we're seeing within the book we think is sufficient to maintain the flow of that revenue.

Chris Manners, Morgan Stanley

Thanks very much. It's Chris Manners from Morgan Stanley. I just had a question on asset quality in the rest of Asia-Pacific and in South America. Rest of Asia-Pacific I know in the first quarter you pointed out a couple of lumpy items in Australia and Singapore, and the charge has come down quite nicely. Just maybe if you could say what you think about your outlook for the asset quality there, just because the impairment charge does look to be pretty low. And same for South America, obviously impairment charge has come down again, and you pointed out Brazil were having a bit of a problem. Is that improving there?

Iain Mackay

Brazil was driven by hard delinquencies within the commercial banking business, principally in business banking, which is the lower end of SME, on the back of very robust growth in the late 2010 and 2011, and almost certainly a little bit too much robustness in that growth. The credit tightening around the business banking business in Brazil has been significant. We're also at a point in that economic cycle where what we've seen is not that unexpected, but we were probably a little bit further ahead on delinquencies than we would have liked. So there's been a fair bit of tightening in the credit underwriting within business banking in Brazil. And then secondly, within retail banking and wealth management principally within the Losango consumer finance portfolio, which again is very driven by a very fast cycle time back into delinquency performance from the economy within Brazil. So that was certainly not unexpected. However, the performance in CMB was something that was a little bit ahead of where we would have liked to. So the tightening that's taken place in those two sectors is having the desired effect I think.

In Asia Pacific, you know, what we saw absolutely related to individual credits in Australia and New Zealand. It wasn't – was it Singapore? I think you're right, it was Singapore, was the other one. But that was it. There were corporate credits that we'd had a pretty close eye on for quite a few months. There were, you know, idiosyncrasies about those credits that required significant restructuring. They're pretty well known credits in the local economy, so they're all over the local newspapers. And that was it.

But when you look at the rest of the quality of credit, whether it's in Hong Kong, the rest of Asia Pacific, whether it's commercial banking, retail banking and wealth management or global banking clients, it remains very stable. It remains very stable. The quality of our mortgage lending portfolios in Hong Kong continues to be very well secured with very low LTVs both in new originations as well as the total portfolio and that's similarly the case across the vast majority of the rest of the Asian markets. So it is stable, you know. It's not migrating positive, it's not migrating negative, but certainly where we sit in this cycle, the team, the risk teams, both globally and in Asia, are watching this. There's an expectation. We've been talking about the expectation for about the last four quarters, that we'd see some deterioration in credit.

Iain Mackay

It could well be. He knows the ones I don't know the answers to, so, you know. Michael, I'll give you one and then we'll do one from Hong Kong and then we'll finish.

Michael Helsby

So it's Michael Helsby again from Merrill Lynch. Just a quick point of detail, and then I've just got a – just on the – I was wondering, clearly on the notable items, if there's any, known notable items that you can highlight, if you like, for us, for the second half?

Iain Mackay

What was the American journalist – the unknown – it's the unknown unknowns that you want me to come up with, is that it?

Michael Helsby

No, well obviously, there's the bank levy, there's restructuring, so just if you can give us your best guess on that, that would be helpful.

Iain Mackay

We've given I think the amount of agonising, over the disclosure that we've done on this, a) to provide you with as much information as we can, whilst at the same time trying to keep the SEC clear because the SEC on a US GAAP basis has got a very different – slightly different view to reserving, as against that which is required by IFRS. There are really no significant areas where we would even be in a position to do reserving under a US GAAP, and if you look at our bank financials in the US you'll see no significant differences around notable items between the bank in the US and how that business in the US is reflected within our IFRS financials.

So from a notable items perspective the areas of uncertainty are laid out as clearly and as completely as we can in note 25, and if you like, in note 17 as well. But the uncertainties that exist that are out there are of a legal and a compliance nature, predominantly in the US. Where we are provided today is absolutely our best estimate based on the facts that we've got available to us, and the other information that we've got available, for example, as it relates to very preliminary discussions with the Justice Department, the Treasury Department and the OCC in the US. And that's what we've got. There is real uncertainty around how the Justice Department concludes on the matters as it relates to anti-money-laundering, and OFAC sanctions, but again we've tried to provide as much information about that as we can. And the reserve we did was based on information that we've got about our facts and circumstances, and triangulated based on very, very preliminary discussions with those agencies.

Michael Helsby

And then just secondly, Alastair was talking about the associates before, and I guess when I'm trying to compare HSBC to other banks, that's one piece that's a) very material from your profits perspective, and b) is very different from what other banks have got, so when I'm looking at the risk-weighted assets under maybe Basel III or the capital deductions, what's the quantum that's actually going to be allocated to those associates?

Iain Mackay

So we do regulate – we do proportional consolidation for our associates, and so the proportion of our ownership of BoCom is reflected proportionally in the risk-weighted assets that we pick up as disclosed by BoCom, so when BoCom – so if you look at the growth in risk-weighted assets in Asia, the risk weight that – the contribution from the associates, because they're growing at a faster pace, is ahead of the contribution from our business in Asia, and it's on the standardised approach, right? But it's a proportional consolidation, which makes no sense. The way it's dealt with in the Hong Kong accounts is that there is a deduction from an HKMA standpoint. But anyway –

Michael Helsby

Have you got the RWAs then that are allocated to Ping An and BoCom, because I've never seen that –

Iain Mackay

So Ping An there's very little, because insurance businesses are deductions, so the only thing that's in there for Ping An is when they took ownership, majority ownership of Shenzhen Development Bank. There's then a bank sitting in Ping An and we picked up a proportional share of the risk – the banking risk-weighted assets associated with SDB. And that was reflected in the year-end financials; it was a fourth quarter effect – a third or fourth quarter effect from last year I think. And BoCom is proportionally consolidated.

Iain Mackay

Okay. Great, that was it. Thank you very much for your time again, as always, gentlemen – and ladies, sorry.

Forward-looking statements

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