Edited transcript

Post-Interim Results 2015

Meeting with Investors and Analysts hosted by Iain Mackay, Group Finance Director

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Corporate participants:
Iain Mackay, Group Finance Director
Jane Leach, Global Head of Regulatory Reporting
Rob Irvin, Head of Business Reporting

HSBC

Iain Mackay, Group Finance Director

Thank you all for joining. Alastair, fire away.

Alastair Ryan, Bank of America Merrill Lynch

One of the hardest things to forecast with HSBC has been your level of confidence about the capital requirements that you face. That's probably been remarkably difficult for you as well as regulators have changed their mind so often about so many things. I suppose one of the takeaways for me from earlier in the week was you sounded a lot more confident than a short while ago on your ability to distribute capital beyond a certain point. So, the question is, what's driving that? Whether it's that you've got more capital and you've got more visibility that you can deliver on the RWA reductions or whether there's a stabilisation in the conversations you're having with regulators or whether it's that the market didn't understand the message you were giving us before. That was one of the messages I thought you wanted us to take away. I might have got that wrong as well.

Iain Mackay

Okay, good question. So, the capital generation of this Firm is very strong. Our ability, demonstrated again this half year, is that when we undertake to do reshaping of the Firm we can do it. The transaction in Brazil will, in all probability, not close this year. Somebody wrote interestingly that they expected our common equity tier 1 to be north of 12% by the end of the year. That won't be the case, because I don't believe for a second that we'll close Brazil until the first half of next year. And organically recognising that our fourth interim dividend is recognised in the capital calculation at the end of the year, net net we will not accrete another 40-50 basis points of capital in the second half of the year, in our view.

Around regulation, I think it's fair to say – and I know Jane will jump in if I overstretch on this point – the expectations of us and our peer group in the UK from the PRA I think is quite clear. I think there is variability, as there ever has been, in terms of what the PRA will require of us, and that will be informed by their review of each individual firm and then them establishing our Pillar 2 requirements. And they provided some clarity last week as to the framework in which they would provide those requirements, but certainly not the quantum other than a broad range,for example, a capital scalar that they may apply.

So, the regime as it relates to the UK, although there are constantly moving parts around the edges of the capital equation, I think we are reasonably confident that we see the shape of that and it's quite clear. There is, for us and for everybody else in the industry globally, uncertainty around what Basel will come out with in terms of fundamental review of the trading book, a revised approach to standardised risk-weighted assets and operational risk. I think on operational risk we have a better understanding of the shape that will take and what that will mean for the Firm. On the fundamental review of the trading book and credit risk and standardised approach revised, we don't. There are further QISs to be engaged on with the Basel Committee, because frankly the first couple they've done haven't provided them with the insights they hoped they were to achieve in terms of redefining outcomes. But the statement that this is not about increasing capital requirements but creating greater consistency is repeated again by people at the Basel Committee – and that's encouraging. But the work through the QISs and the consultation is not how we or the rest of the industry has interpreted those outcomes.

What I think there is a shared understanding of is that it is unlikely for there to be clarity on this until well into 2016 or even 2017 and its implementation, if in fact we're implementing anything, is any earlier than 2017/2018 or even beyond that. There is an increasing – and I wouldn't call it political – regulatory discussion around whether, in actual fact, we need to do anything. Models are now reviewed extensively by regulators and they're controlled tightly by the firms. There was a belief that a revised approach to standardised could create greater consistency and compatibility across the industry. Is that really a desirable thing? And unless you can come up with a framework that is reasonably responsive to risk, what actually have you accomplished?

So, where this goes – you spend your life on it, Jane. I don't know whether we can provide any greater clarity other than the fact that, on Basel, there are uncertainties out there, 2-3 years or 3-4 years ahead of us. The discussions are constructive ones; there's lots of consultation; there's lots of QISs; there's good collaboration. But, again, our view is that if we end up with significantly higher capital requirements, we'll take whatever actions are necessary to adapt the business model to it. But those are not the risks we can prepare for right now, because we don't know what we're preparing for. The risks that we monitor on a regular basis and do prepare for, and how we manage them, are those which are giving confidence around our ability to generate capital, preferably through the organic profit-generation of the Group. And, as and when appropriate and informed principally by the six-filters review that we do on an ongoing basis, reshaping of the Group through disposition of certain operations and entities.

So, we're confident in capital generation from operations; we're confident in our ability to reshape the Group to meet the requirements of the market, aligned to the strategy, focused on that international network supporting trade and investment; and we're managing, as actively and progressively as we can, the risks to capital that face us. And I think we've got a pretty good handle on it. But, I mean, if you go through our numbers, every single quarter there's regulatory adjustments coming through. They tend to be on the fringes – touch wood, now. But it's constantly moving. The big risks out there, I think, are two to three to four years ahead of us, in the form of the Basel issues. We'll get clarity at the end of this year about TLAC, but we've always known TLAC was coming. We kind of know the quantum that we're probably going to have to do; we kind of know where we're going to have to do it. We've got a reasonable idea of what it's going to cost us.

It won't be easy to do in certain markets, but, as we talked about back in June, we've probably got $12-13-14 billion to do in Hong Kong. Why the hell we should do it in Hong Kong I don't know – but that's probably what the law's going to tell us to do. We're doing the preparatory work now to put in place the intermediate holding companies from which that debt would be issued. We'll work with the ratings companies to get the ratings for it, and we'll put ourselves in a position where, hopefully, early next year, once we've got clarity from the FSB at the end of this year, we will crack on and do what we have to do.

Alastair Ryan

The incremental confidence that I took away from the half year numbers versus a couple of months ago on your ability to repay capital – was that more to do with that the market hadn't paid attention to what you'd said before or was there a change? What you've described there is very fair, but that would have been true three months ago.

Iain Mackay

You're absolutely right, Alastair. The message sometimes hasn't been spoken, but the intention's been absolutely consistent. For three years now, when Stuart, Samir, myself and others have sat down, we've said, 'Look, to the extent that we've got surplus capital to distribute, we would do it either in the form of special dividends or share buybacks.' That's still the case. In fairness to everybody in this room and on the call, what brought that back to the focus was the discussion around $290 billion of RWA reduction.

There were very good questions from yourselves and investors about, 'Right, well, if you can't redeploy $180-230 billion of it, what are you going to do with it?' Certainly, in the work that we've done as a team leading up to 9 June, if we can't redeploy that in profitable business, generating returns ahead of the 10% return on equity, then it goes back to shareholders subject to regulators saying, 'Yes, put it back to shareholders.' And we've got this brilliant propensity to do an investor day and then usually within about four to five days either the Chinese market goes to hell in a handbasket or the European market goes to hell in a handbasket – so I think we should probably stop doing investor days for the sake of the world economy.

Now, we'll probably get on to Chinese questions on the back of this, but our view is that we've got a very clean line of sight to redeployment of about $150 billion and then, depending on how the world develops, life could get more interesting. And we will reduce $290 billion. We did 50 this quarter; we know what we need to do. Most of it is within our control. About $30 billion of it really requires regulatory approval around models. We will probably get it, but it will take longer to get. We have 290 we will realise. We will only redeploy where we can see a clear line of sight and the business that we book is generating the return on risk-weighted assets, the return on equity that we've targeted as a Group. And if the market is just not there to do that within our risk appetite, then it will go back to shareholders. And, in all seriousness, this will not happen before 2017, but what will inform that is meeting regulatory requirements and having confidence that, if there is more coming at us, we can deal with it.

Jane Leach, Global Head of Regulatory Reporting

Just a couple of things, I think, to add. When you look at the shape of the capital build since Q4, through Q1/Q2, there were a couple of things in Q1 that were actually pulling the ratio down slightly. We had some negative FX in Q1, which has actually come back again now. We had some positions in IRC [Incremental Risk Charge] that we discussed at this meeting that have then come off. If you look at Q4 to where we are now, I think it's a helpful thing to do.

On the regulatory change, I know we've discussed it at a meeting some of the upcoming regulatory changes. And we've talked about the quantification of those in the past, but, if we look forward to where we are now, in the immediate future, I would say – touch wood – there's less immediate stuff coming in, actually, as far as we know. And you can never be completely sure, but that's what it seems like. So, the regulatory change stuff is further out, and that's why it's more difficult to quantify – and it's affecting the whole industry in the same way. But there is that level of uncertainty on regulatory change, because it's that much further out.

Raul Sinha, J. P. Morgan Cazenove

Sorry to bore you on the same topic again, but if I can just draw out a couple of your comments there, you mentioned, on operational risk, you seem to have a better understanding of the rules or the impact as it might fall on you. This is one of the things I really struggle with, from the outside: to understand why, for example, Citi's operational risk is three times your operational risk when the balance sheet is the same size in terms of RWA. So, if you can explain why you feel more comfortable about that, that would be very useful.

Iain Mackay

Jane, do you want to have a crack at that one?

Jane Leach

I think this is on AMA [Advanced Measurement Approach].

Raul Sinha

Yes, the fact is you're standardised; they're advanced. But why should one bank have three times operational risk RWAs as you?

Jane Leach

Yeah, the other thing you have to bear in mind…

Raul Sinha

Every other US bank is similar.

Iain Mackay

Yeah, they are – and look at some of the issues. I mean, you know how AMA work, right? You don't just pick up your idiosyncrasies; you pick up all the rubbish that's going on in the industry at the same time.

Raul Sinha

Isn't that how operational risk is supposed to work? Couldn't you argue that standardised is underplaying operational risk RWAs and eventually the regulator will wake up to it?

Jane Leach

Yeah, this is something we sort of mentioned at investor day, but we're not able to quantify for you. You do need to remember that within the Pillar 2A framework that picks up a number of things. It picks up concentration risk; it picks up pensions; it picks up operational risk as well. What you'll find is different banks have got different elements of operational risk within their Pillar 2A. It's not something we're able to quantify with you, but that is an element in there as well.

Raul Sinha

From the Basel paper you can work out the impact, obviously, on your operational risk. Would it be fair to say that the Basel paper changes you recognise now on your firm? Clearly, there's an offset inside Pillar 2A that you can't tell us about, but that's what makes you more comfortable about the net impact.

Iain Mackay

It somewhat informs that. It's also somewhat informed by the work that we've done with the PRA around operational risk over the course of the annual review that they do through SREP [Supervisory Review and Evaluation Process]. They look at it, really, as part of internal capital guidance and Pillar 2. We had done our own modelling around Pillar 2 requirements, operational risk requirements. And when we sat down with the PRA at the end of – when was it, three months, four months ago? I can't remember the time. Marc Moses and Jane and I were sitting in the meeting with the numbers they put in front of us and a page in front of us that kind of had our version of the numbers. We went into that thinking, 'We could get hit with a really big number here,' and the number they put in front of us was almost within pennies of the numbers we calculated by modelling out what we thought would be a conservative approach to operational risk capital. That doesn't mean it's not going to be influenced, whether by further interpretation from Basel or changes in attitude from the PRA, but I think the PRA tend to take a fairly conservative stance on this; I think we've taken a reasonably conservative stance. The numbers are aligned, and we look at our capacity to deal with that.

So, the theory around advanced measurement approach is that you can then task the guys doing the work with customers, the transactions, the people running operations, about how can you identify elements within your advanced measurement approach and manage your operational risk down? However, what the Basel paper goes to is perhaps, 'The advanced measurement approach won't be there any longer.' So, although we've started investing in the deployment of advanced measurement approach, there's a little bit of, 'Hang on a second. We maybe shouldn't spend a whole bunch of time and money doing this, because it could disappear.' But as an approach to modelling a conservative understanding of operational risk capital, it's quite useful.

And that's really how we've built up the model, but in truth we're probably not going to spend a lot of time now trying to implement detailed AMA models. We have some of them around the Group. The US business runs off AMA at the moment. But we will use some of the modelling to help better understand where the operational risk capital is.

Now, the next thing that goes onto that is, do we then take that capital cost down to each individual business, down to each function? Do we take it to Andy Maguire and say, 'Andy, you can do this stuff, which, if you are successful, would allow us to reduce the operational risk capital.' I think the industry, we've got to form a view that, even if we got really good at that, would we realise real economies in capital. Is that where we should put the effort in or should the effort go where the effort is presently going, around improving the quality of information around collateral, collateral matching, netting across customer transactions, dealing with the same customer across six different balance sheets and how do we get better synergy across a smaller number of balance sheets and better matching of transactions? How do we improve basic underlying qualities so it improves the modelling and the accuracy and the sensitivity of the models that we do?

And you can see real benefits coming from that work. Therefore, maybe, that's where we should work. There's no 'maybe' about it: that's where the effort's going at the moment.

Raul Sinha

Can you say anything about the stress test? Because some people were surprised yesterday about the inability of one of your competitors to rule out a capital increase. Stress tests were cited as one of the factors there.

Iain Mackay

I think I can say with reasonable confidence I can rule out a capital increase. I think the stress test, as the press has written, was a real stress test for ourselves and Standard Chartered and, I'm sure, for others this year. I can't and won't share the results; it's confidential until the PRA publish it.

Raul Sinha

When do you know this?

Iain Mackay

December.

Raul Sinha

You get the results in December.

Iain Mackay

We know what we've submitted to them. We submitted to them results on 16 July.

Raul Sinha

That's your own ICAAP [Internal Capital Adequacy Assessment Process]?

Iain Mackay

That's our stress test. They give us the scenarios; we enrich those scenarios. We run it through the millions of data elements. It gets reviewed and challenged. Russell and Alan Smith play a huge role in that, as does Jane, as do Sarah and the team out in Asia. Across the Group, they play a role in reviewing and challenging. And that goes up to our Group Risk Committee. That got submitted on 16 July. We were happy with the outcome of that. I think it demonstrates the resilience of the Group in a fairly stressful environment. Beyond that, you'll find out. What the PRA now do is they sit down with us; they review and challenge some of the models we've used, the data we've used, how we've reached the scenarios, how we've applied it.

Now, based on learning last year, we were well connected with the PRA about how to apply the stress test. I think we got better at that with the PRA this year in terms of, 'Right, is this how we should apply it?' pick up the telephone, ask for guidance where necessary. But still, there will be review and challenge. The Chair of our Risk Committee met with the PRA last week and had a one-on-one with them. I met with them yesterday. Mark is meeting with them this afternoon. We'll go through the process.

Raul Sinha

Excellent.

Chintan Joshi, Nomura International

Just carrying on, on that operational risk question, if you look at your Brazil sale, $9 billion will come over the next three years. You've sold a ton of businesses over the last three years. Shouldn't that mean there's a tailwind on the operational risk number or am I missing something?

Iain Mackay

No, you are, in the round, right. Most of them are pretty small. The one that had some carry was the credit cards in the US. The last, if you want to say, relief from operational risk will come off this year.

Jane Leach

If you look at the legacy line in the published numbers on RWAs, you'll see that there's an element in there from the cards in operational risk, which we've been carrying. I think we have $1 billion.

Iain Mackay

$1 billion, yeah.

Jane Leach

So, we have the same situation there.

Chintan Joshi

Not much left on that end anymore, okay.

Jane Leach

If you go back to previous results, you'll see it come off.

Chintan Joshi

Okay, fine. Then, just changing tack to a few other issues, on costs, you had told us last quarter to think about a $9 billion kind of run rate through the next kind of three quarters. I don't know whether FX has changed that number, but would you still stick to that?

Iain Mackay

I think we'd stick to that, wouldn't we, Rob, pretty much?

Rob Irvin

Yeah. And the FX – when we looked at that in Q2 – has hardly changed at all.

Iain Mackay

Just to be clear, I think I confused people on the call between $32 billion and $31 billion. The difference was the bank levy, so that's how we get from $32 billion to $31 billion. That's the bank levy.

Chintan Joshi

And can I understand why costs swing so much from $8.5 to 9.1 billion between the two quarters? Because the run rate changes quite substantially. Is it kind of investments you did that caused it to go to $9.1 billion? I'm just trying to think about what's underlying, what should we think about in 2016/2017.

Iain Mackay

If you take the single largest element, it was in staff costs. And that was reflected in higher headcount coming through both Operations and Compliance, both related to Global Standards. It came through investment on Commercial Banking, Global Banking and Markets again through payroll. We had a step-up in the bank levy.

Rob Irvin

We had a bank levy accrual release in Q1 and that wasn't repeated in Q2. We paid the FSCS levy in Q2.

Iain Mackay

And that makes up $500 million.

Chintan Joshi

Okay, that helps. I wonder why I didn't see this anywhere in the text. It would have helped.

And then if we talk about the UK deposit market, you're losing quite a lot of share on current accounts, 8% in 2014, in terms of the switches, not in terms of your balances. What is the strategy going forward there? Is it something that you're worried about and you might look to change your strategy there or are you happy to lose that 8% of share on the amount of switches?

Iain Mackay

In terms of different brands within HSBC, we've been net gainers on First Direct and Marks & Spencer Bank. We've been absolutely steady on Premier. Mass affluent we've actually been net positive and Advanced we've been net positive. But overall, I think, when it comes to looking at the statistics that are published, we've lost a lot of numbers, but we've also attracted a lot of numbers back. So, net net, we've had a net positive over the period of the last quarter, April-June, in terms of accounts leaving through CAS [Current Account Switch] or of their own volition, because they don't need to go through CAS, versus coming into the Bank.

Chintan Joshi

So, the 2014 trend has turned already.

Iain Mackay

Yes.

Chintan Joshi

And is that because you're taking specific measures?

Iain Mackay

Well, it is. It's improving, frankly, customer service.

Chintan Joshi

I was thinking more like the deposit rate.

Iain Mackay

No, it's not deposit rates. It's absolutely not deposit rate. It's customer service. If you sit down with Andy Maguire or you sit down with John Flint, they will talk to you in detail about what we're doing around the customer service proposition in the UK and HSBC brand. It's been inconceivable to me and many of us for an age that you can have the best brand in the UK from a customer-service perspective in First Direct and one of the poorest in HSBC. What do you need to do? There's obviously a learnings position you can take what we do well in First Direct and transpose it. And, in fairness, that's what John, Antonio and Francesca have been focused on over the last 18 months to two years. But in terms of getting any real traction both in deposits and current accounts and on mortgage share, it's only been in the last 3-4 months that we've seen positive traction on that. Again, on mortgage share, we lost share last year, but over the first six months of this year we're starting to rebuild that share. And it's not through pricing. It's nothing other than improving the proposition and the service that supports it. It's speed to answer, basically – and then, once you get to an answer, being able to close out the transaction that you agreed in an efficient manner. I think we have increased the market share data – it's on the same pages – around mortgages. We've grown from, I think, 6.3% of new originations up to 7.6% of new originations. We've stepped up our shares of first-time buyers approvals as well. It is not pricing initiatives for the most part; it is just a hard focus on responsiveness to customer enquiries. And it's not as yet coming through the broker network. We have Countrywide as a broker, but we're adding another. We're adding one more. The volume that we got through Countrywide was peanuts.

Chris Manners, Morgan Stanley

Basically, if we get the operational risk-weighted assets to go up and effectively take it out of Pillar 2 charge and put it into Pillar 1, so your RWAs are up but your PRA requirement comes down, would that give you a chance to reduce your 12-13% expectation of where your steady state might be?

Iain Mackay

It's changing buckets; it's not changing the total quantum.

Chris Manners

Your RWAs would go up; your capital ratio print would go down. But then would you still target 12-13% or would you be able to say, 'It's actually 11.5-12.5%, because 50 bps have gone into Pillar 1.'

Iain Mackay

I haven't thought about it.

Chris Manners

You haven't thought about it.

Iain Mackay

And I won't waste my time thinking about it until that happens.

Chris Manners

Okay, fair enough. The other questions was on Fed rate hikes. Obviously, well flagged: it should be happening – it should be.

Iain Mackay

Yeah, it's been happening a few times before, hasn't it? I like your confidence, Chris.

Chris Manners

And obviously there's a big benefit to HSBC in terms of ability to catch a better deposit margin. I know you've given us disclosures on that in terms of what that is on a static basis. Could you give us a little bit of a sense of what behavioural implications are for what your customers might do? Might they switch from current accounts to savings accounts or things like that? Also, where do you see the risks around that? Is there asset quality risk, Hong Kong house prices? What about the oil and commodities complex with a stronger dollar – and that sort of thing?

Iain Mackay

As to customer behaviour, I can't remember the last time interest rates went up to be able, frankly, to draw on that. Sarah doesn't have a mic, but, Sarah, do you have any observation on Hong Kong in that regard? Not really, it's been so long I can't really remember.

What I can say is when we did deposit campaigns in the US bank back in 2008 and 2009, when we had an online savings account that was priced slightly differently. And what we saw within our customer base was moving from in-branch deposits to online savings accounts deposits, because they got a couple of basis points more on it.

It would depend on how we set up the proposition between deposit accounts. Special online savings accounts and such like would drive customer behaviour. Clearly, it would be our intention to take any change in rate and filter a proportion of that through to customers. Assume you get a rate increase in October, the likelihood of seeing any real benefit of that to our P&L in the last couple of months of the year, I think, is pretty muted. In terms of read-across to credit quality, if you look at how the mortgage portfolio is underwritten in the UK, in Hong Kong, in the US or any major centres, we have – certainly for the last 3-4 years – stressed mortgage origination with upwards of 300-350 basis point interest rate normalisation, from an affordability perspective. So, for somebody who took a mortgage with HSBC in the UK, for example, in the last three years, we extended a mortgage based on your ability to afford not the rate today but the rate today plus a 300-350 basis points step-up. Therefore, a 25 or 100 basis points step-up, in our view, should not result in a step-up of any significance, or any step-up, around credit cost in our major mortgage portfolios.

To the extent we've got unsecured positions, that's possible. But as you also know for the last four years we've done a lot of switching from unsecured to secured credit. That's reflected in our credit cost, it's reflected in our margins. But we still have some unsecured credit books here in the UK, in the US, in Mexico, in Hong Kong. But they're a very small proportion of the overall balance sheet, from a Retail Bank Wealth Management perspective. And it's the Retail Bank that is the canary in the coal mine when you start seeing stress coming through in higher rates. So I – that would be the natural response, but I'm not sure necessarily 25 basis points does it to us. I think when you see sort of 50, 75, 100, 125 basis points, then we probably will see higher credit costs. But I'll also see higher income coming through my net interest line.

Ian Gordon, Investec

Just a predictable one. Can you just follow up on what you said on the call on the Hong Kong numbers in terms of how much of the game we saw in Q2 might dissipate with the turn down in the Chinese market?

Iain Mackay

Alright, from the Retail Bank Wealth Management, Equities. So the effect of Shanghai, Hong Kong Stock Connect has been to progressively increase volumes. And we have a much stronger platform, and much greater capacity to serve those volumes in Hong Kong than anybody else. So we've seen our share of that grow significantly. There have been higher volumes, and obviously a lot of volatility, over the last six weeks in the Hong Kong book. That has been certainly beneficial to us. It has not represented a particularly significant or material part of the revenue base. It's been nice to have. The expectation is that we won't have that little layer of cream on top of the cake going into the third quarter and the fourth quarter, although there's still a lot of volatility and a lot of volume coming through that vehicle. So overall there's a step-up in revenue. You might say there have been two steps up; I think we lose one of those steps. But we don't see it as – we would expect slightly lower revenues in Hong Kong, in Asia in the third quarter, but not to a significant degree.

Ian Gordon

Thanks. And then secondly obviously at the strategy day you commented that it was market conditions which gave you the confidence and the optionality to accelerate non-core run-off. Given that you've now got additional capital capacity, or on a pro-forma basis you have, how do you think about your options in terms of possible further acceleration of run-down, either in legacy GBM and/or North America?

Iain Mackay

It is firmly in the middle of $290 billion run-off. Samir has got $140 billion of that to accomplish, of which $110 to $120 billion is not modelling. It is actions that need to be taken by Samir and his teams around legacy credit, ABS portfolios. There was good progress made in the first half of the year with about $14 billion being run-off in that respect. There was a total of $40 billion at the beginning of the year, so he's still got about $25 billion to go.

Jane Leach

Yes, $44 billion including everything at the beginning of the year.

Iain Mackay

So he's still got $25-30 billion to go, and his focus is in getting that off. That was effectively P&L revenue neutral for him in the first half of the year. As far as the CML [Consumer Mortgage Lending] portfolios go, we distributed through sales another $500 million tranche in the first half, and we've got another $1.5 billion in the pipeline which we would expect to close in the fourth quarter. And we would like to go faster on that second – well, we'd like to go faster in all of them. But the second element has an operational factor to it. To dispose of this and to avoid kick outs, kickbacks, any future servicing issues with the acquirer, with changes in federal law on servicing the file quality has to be flawless. So what Pat and the team are doing systematically, for every single credit file, is they're going through, with a checklist, and making sure that the documentation is there, is of the right quality, that the i's are dotted, the t's are crossed. One, it improves efficiency around due diligence. Two, it improves pricing. So you're given a very high quality set of files you don't get a whole lot of discussion around pricing. Three, you don't expose yourself to future compliance challenges around that new owner of the file going out and being unable to service because of shortcomings in the quality of the file that was sold.

As you can imagine, in $1.5 billion of sub-prime mortgages, there's a lot of files. So the focus is on continuing to put a lot of bodies on getting files cleaned out so that Pat and the team can go and get after what is a $10 billion slug of sub-prime mortgages that they see as being a) attractive from a market perspective, b) attractive from an economic standpoint, pricing for ourselves. So he did half a billion, he's got another $1.5 billion to get done in the second half. And then what he's principally focused on is accelerating file due diligence.

Chintan Joshi

And it sounds like you're talking about pretty small disposal losses.

Iain Mackay

So basically break-even/small gain in the first quarter. And certainly if you go back over the last 18 months of the positions it's been either very small gains or very small losses. Basically a break even proposition the whole way through.

Jane Leach

On the CML portfolio, if you're focusing on RWAs saved and you're looking at the reductions that we've had in RWAs that's not the totality of what we saved with the CML run-off, because CML also has an EL [Expected Loss] minus P [Provision] capital reduction. So to the extent that we are disposing of defaulted portfolios, the bigger gain actually is in the EL minus P line. So the gain that we get from that is bigger than what you see from just the RWA.

Chira Barua, Bernstein

Two quick ones. One in which we've been talking about this whole debate about capital deployment, nearly $300 billion, $290 billion or whatever, and then putting it back across the world. There's never been any talk around inorganic opportunities. And with any emerging market stress that comes around there'll be assets definitely on the market. Just want to understand, from a management point of view, is it like a sacred cow right now that you'll never acquire anything after all your experiences in the past, if you have the capital and the opportunities? Just wanted to understand that.

Iain Mackay

Not a sacred cow, but there are – we don't spend a huge amount of time talking about it, but operationally as a management team we have a lot to do from an implementation perspective. If you look at – and you just take one of the 10 items we talked about on 9 June. Meeting the requirements of the deferred prosecution agreement for us is an absolute non-negotiable. We operate in 71 countries around the world. We have to deploy in those 71 countries technology that – at the moment it's people mostly. But we're literally in the process of deploying technology that will progressively allow us to reduce the number of people engaged in this work. But it is deploying, with precision, our ability to scan and monitor every payment that goes through the Bank, every customer that comes into the Bank, and know them – and in many cases their customers – intimately well. And that is an incredibly intensive piece of work for our teams to do, and it impacts our frontline teams around Know Your Customer, and engaging with customers, the whole way through Operations into the Financial Crime and Compliance teams working for Marc Moses and Bob Werner.

That is an extremely intensive piece of work. One of the things we do not particularly want to do is make life more complicated for our colleagues in that space by doing acquisitions, because when you acquire you have to do a 100% – you don't have to do, but we would do to protect the firm – a 100% re-do of customer due diligence of every customer you take in the door. We've done two acquisitions in the last four years. One was Lloyds or Barclays branches in Dubai. Tiny, but we did 100% due diligence on our customers that we picked up there. The second was the Oman bank. And the same story. We did 100% integration of systems, people, processes and 100% due diligence of the customer base around financial crime. Again, in any part of the world you have to do that, but in that part of the world it had to be done quickly. While you're doing that, you add complexity from ensuring that we meet on time, as we have done up to this point, every requirement that the monitor has put on us.

So it's a purely pragmatic response to the execution pipeline that we have sitting in front of us as a management team, and not overcomplicating what is already complicated for the teams. Stuart made allusion to the fact that we continue to look at the shape of the firm and apply the six filters. And we're sitting with 71 right now; we've completed Brazil; we're working on Turkey. But we're also continuously looking at – we know we've got our 20 priority markets. We know that to be effective across the wider network in terms of supporting international trade and international investment there's another 20-30 markets that really are meaningful to us, and are meaningful opportunities for us. And then there's another 10 to 15 to 20 markets which you start having to go, 'Well, hang on a second, what really is the value of having them in the network?' And that's an ongoing process. But when you think about the complexity around whether it's Financial Crime Compliance, Regulatory Compliance, Wider Conduct Compliance, there is a cost. And it just becomes purely an economic – it becomes an equation. So it's not a sacred cow, but we're not going to add great complexity by taking on acquisitions whilst we work through these issues over the next two to three years.

Chira Barua

That's helpful. The second question is on mortgage floors. That is not something that we've talked about in the UK and you have already experienced it in Hong Kong. What's your opinion on that? If it's coming and what kind of impact are we looking at for you?

Iain Mackay

Mortgage floors – I thought you said flows.

Chira Barua

Yeah.

Iain Mackay

Jane, do you want to take that one?

Jane Leach

Yeah. Obviously we see it in Hong Kong and those come through at Group level, so you'll have seen a small increase in RWAs of two billion (USD) for the rollout of the floor across the whole book in Hong Kong. So there have been some discussions in the couple of years about the possibility of a floor from the PRA. It's considered to be low risk. So those discussions, it doesn't – it's not something which has been widely discussed recently.

Chira Barua

Okay, thank you.

Martin Leitgeb, Goldman Sachs.

Yes, I wanted to follow up on a couple of slides you showed earlier on investor day, mainly with regards to the ring-fenced entity in the UK going forward. And I was just wondering how you're thinking about the dual capital requirements here, so one core tier 1 and the other being leverage. Is the assumption that this ring-fenced entity going forward is likely to be constrained mainly by the leverage ratio, or will you have a sufficient amount of higher-risk weighted assets, whether it's unsecured or similar, within that ring fence, in that sense to balance the requirements? Thank you.

Iain Mackay

Yeah, good question. Thanks, Martin. So I think it was Lloyds that was talking about this last week, wasn't it, about what the capital and leverage requirements would be within the ring-fenced bank. If they apply the same capital standards as applied to Group today then I think we'd be in great shape, right? I think there's perhaps a suspicion that there'll be a fairly healthy TLAC requirement. Also, given the extent of capitalisation of that, the TLAC requirement and a leverage requirement, I think modelling what would be in the ring-fenced bank, which for us would be the Retail Bank Wealth Management and the Commercial Bank, in their entirety effectively, possibly the Private Bank also as a subsidiary of the ring fence bank. It will be well capitalised, it will be extremely well funded. Because we'll have Commercial Bank in there the leverage ratio will probably be in reasonably good shape. But if they stick a 5% leverage ratio on it, and a 15% common equity tier one requirement, then…

Jane Leach

We don't know yet where that ratio requirements going to be, so it's quite difficult to tell.

Iain Mackay

So that's sort of idle speculation. Again, I think when we look at HBEU and the conversation that we have with the PRA today it's around ensuring consistency of capital standards with the Group as a whole with the UK subsidiaries. But when you go back to the Vickers Commission and – I can't remember what's in the Banking Reform Act specifically, but certainly working through the Commission there was talk about a significant TLAC requirement, a higher common equity tier one requirement and a higher leverage requirement. Why you would do that with an entity which has got inherently lower risk assets would seem slightly odd. And again I wouldn't necessarily put too much confidence on it, but the PRA is thinking about this quite carefully. The difficulty in that is that it's not necessarily the PRA's decision. It's the Financial Policy Committee's decision. And at the risk making politically influenced comments I'll stop there actually.

Jane Leach

Having a broader ring fence does help. If you've got just very narrow on mortgages then leverage tends to therefore be higher than CET1 requirements. But we don't know where either ratio or the leverage ratio requirement's going to end up. And having a broader ring fence is helpful.

Iain Mackay

And we may not find out until 2017. So we'll see. I think 2019 is when it needs to be put in place. And we're working towards having it up and running by 2018. Okay, we'll take Tom on the line and then we'll go back to the room if there are any questions there. Tom.

Thomas Rayner, Exane BNP Paribas

Hi, morning everyone. Just a couple, please, from me. Iain, just to check your comments on the full year jaws, whether you really mean it, I guess. It clearly looks difficult, given the first half trends. So just I wonder if you could add any further colour to the second half. Obviously we're going to start seeing, I guess, some cost-to-achieve numbers coming into the second half so maybe there's some cost issues around that. So I was just interested if, having had more time, you would still want to commit to a full-year positive jaws number. And then I just had a second question, which might be for Russell if he's there. Do we just forget about the BoCom headroom issue now – fair value's not far from the carrying value, and I guess you have to keep doing the impairment test. But it's looking like it's something we don't need to concern ourselves with. Thanks.

Iain Mackay

So on BoCom, firstly, about $1.5 billion headroom. We do continue to revisit every quarter. At the risk of sticking my next out I don't think impairment will be an issue this year.

On positive jaws, as a general rule, Tom, I try not to say things I don't mean, which I will admit does confuse people occasionally. No, the way we set up our plan for 2015 had actions being taken in the first half of the year that would deliver cost saves in the second half of the year, so the cost profile – and this has got little to do with the $4.5-5 billion. It is how the plan was set up in the autumn of 2014. The businesses and the functions have those actions in hand and we have to deliver those savings. If we fail to deliver those savings, a) we'll have some really interesting conversations as a management team, but, to be clear, sitting on negative 2.9% jaws at the half year, we've got a challenge on our hands.

But, as recently as Wednesday morning – Ian Jenkins and Stuart and I sent out notes to a number of miscreants who are not hitting their cost numbers, asking them to get their act together and telling them what they needed to accomplish by the end of the year, and impressing upon them the importance of hitting positive jaws for the full year. There is absolutely no doubt it's going to be difficult to do, but that is what we are going after.

Thomas Rayner

Okay, because, if I was one of the miscreants – which I often have been – I'd be saying, 'Okay, I can do what you say. I'll do my best on cost', but some of the things you are flagging on second half revenue – think margin trends are a little bit weak, was some of the commentary – obviously the stock market – Chinese stock market. If the revenue doesn't continue at the same sort of pace, then it obviously becomes impossible to do it purely with cost management, I guess.

Iain Mackay

Yeah, you know, if Samir's business had a fourth quarter like it had last year, yeah, it would be difficult, because, frankly, in the month of December, if you get a horrible November and December coming through Global Banking and Markets, with the best will in the world, there's not much that Samir, John Flint, Simon Cooper, Andy Maguire, myself, Marc Moses or anybody else can do to offset it in one to two months' worth of activity. So this is, monthly, we sit down with the team. Ian and his team are putting detailed MI in front of us, where we go through obviously every line of the P&L and are tracking where we are against the plan for each of that P&L, and, if we're coming off it, we're asking people to take actions, hence some of the emails that were sent to a number of our colleagues on Wednesday morning, saying, 'Guys, you're off track. You need to take action. Take it now, please. If you don't take it now, you're not going to have enough time to get it done.' That's what we need to do, to be able to pat our head and rub our belly at the same time.

Thomas Rayner

Okay, thanks a lot.

Iain Mackay

Okay, thanks, Tom. Any others in the room? Chris.

Chris Manners

Thanks, Iain. Sorry, it was just a follow-up question there, actually, on the jaws. Is that including the bank levy or excluding it, and do you have a sort of estimate of what the bank levy might be for this year?

Iain Mackay

It's including. Right, so it's ex cost to achieve, but including the levy. So the levy for us is not a significant item, because it's here to stay, right? But it's excluding cost to achieve, so restructuring costs, for example, okay?

Chris Manners

Perfect, and are we still looking at $1.5 billion for the levy for this year?

Iain Mackay

$1.4-1.5 billion, yes.

Chris Manners

So that's – okay, perfect. That makes sense.

Iain Mackay

Okay. Yep, down at this end.

James Invine, Société Générale

Hi, it's James Invine here, from SocGen. I just wanted to ask about your credit appetite at the moment. I mean, I think you told us six months ago that your impairments were coming in below your expectations, so much so that you were checking that the businesses were using the risk appetite that you were giving them.

Iain Mackay

Yes.

James Invine

Have you done that exercise? Were they taking full advantage of the risk appetite? Is there still more to go on that?

Iain Mackay

Yes, we did, and no, they weren't, and there's plenty of capacity. So there is an appetite which… There is credit appetite and there's market-risk appetite. I think it's certainly the case that Samir and the team are making better use of market-risk appetite over the course of the last three to six months. On credit, I think, certainly within the Commercial Banking space, that would be the case. I think what we're watching closely on the Commercial Banking space is that you're using the credit appetite and you're generating returns for the capital that you're putting to work. As you can imagine – and I think Tom just alluded to it – people sometimes can get carried away with the notion of generating revenue. I don't really like revenue that doesn't add up to the returns that we want within the Group. So we have had a conversation with one or two countries that were great at packing on revenues but, when you looked at the return it was generating against capital consumed, it wasn't as good as it needed to be.

In the Retail Bank – again, one of the comments that we got into earlier about UK market share – we've started pulling back to where we were before, so we built market share very nicely as others were kind of sitting on the side lines, unable to do anything. As they came back onto the park, became more competitive, we didn't really respond quickly enough to that, and some of the things that John and Antonio and Francesca and the team in the UK have done, for example, is just be a little bit closer to where they need to be from a risk-appetite perspective, and backing it up with the service that improves that so we can rebuild market share.

So there's a better focus now, but I think, as Stuart said on Monday, there's still a robust credit capacity and credit appetite.

James Invine

And how sensitive is that to your view of the macro? So I think you talked about 7.1% China GDP expectations. I mean, if you change your view, think that's going to be five or four, how much does it change the appetite, or are you just so confident in the business you're writing that you think your credits are so strong they could withstand a much worse outcome?

Iain Mackay

As a rule, we're underwriting credit with a view that that credit needs to be able to withstand a certain amount of stress, whether it's corporate real estate, manufacturing, commodities, residential, pretty much whatever. I think it would be fair to say that we see slower growth in China, but that slower growth is reflected in the business that we're writing. So the teams dynamically are looking at the environment. It's not as if Stuart says, 'Look, it's going to be 7%, so just keep firing away.' Helen and the team in China are reflecting on what they see coming across their desk in terms of opportunities and underwriting it on a case-by-case basis. But it is informed by everything that we read in the newspaper, which, by the way, isn't terribly well informed very often, but obviously also informed by what they're observing on the ground in each country in which we're operating.

Yafei Tian, Citi

Over the past two quarters, we see a lot of volatility in FX and the impact on capital, so I just wanted to check with you what are the major currencies, that affect FX movements, particularly considering there are a lot of policy-rate divergence across the globe. We expect a stronger dollar going forward, so how does that impact your FX?

Iain Mackay

In the second quarter, there was virtually no effect on capital from foreign exchange. It was pretty straightforward.

Jane Leach

For the total of the two quarters, if you take a net of the capital movement, which tends to be in one direction, and the RWA movement, which tends to be in the same direction, but one of them is positive to the ratio and one would be negative, the two together, the impact in the first half was very low, actually, so 1bps.

There were some movements in one direction for Q1, and then back again for Q2.

Iain Mackay

When you look at the main currency pairings that tend to drive that, it's euro-US dollar, US dollar-sterling.

Yafei Tian

Is your sterling still hedged, or have you increased your hedge?

Iain Mackay

No, the hedge is still in place.

Yafei Tian

And is there any implication on cost if dollar gets stronger? Will it be easier for you to achieve your targets?

Iain Mackay

So one of the things that we went through with you on Monday was that we constant-currency to give you a track on what we're trying to accomplish, so that's the $31 billion that we talked about on Monday. So, each quarter, we'll give you the constant-currency view of what the run rate should be.

Yafei Tian

Right, and the second question is on Commercial Banking. I noticed that, this quarter, you deploy a lot of the additional RWAs in this area, but we see a lot of softness in this business, not just from yourself but also from your competitors in terms of margin pressure and also volume growth. Just wanted to pick your brain on what's the outlook that you see for this business going forward, and is there any implications on the credit costs, given global softness in commodities?

Iain Mackay

In global trade and receivables financing business, volumes have been lower, largely influenced by the commodities space. Actually, margins have remained very consistent. They've been fairly stable in the trade space for about the last four to six quarters now, so, although we didn't see – at least at this point, I think it's reasonable to assume we might see a little bit of pressure in the second half of the year or going into next year on this, but the volumes are down, informed principally by commodities.

On the other hand, we've seen good pick-up on credit and lending in the UK, in Germany, in the US, in Asia, where we've actually seen balances build over the course of the first half of the year, and then between quarters, first and second quarter. That's equally true in Hong Kong as it has been in some of the other markets I mentioned. So what we've seen – a little bit slower in trade; we've seen pick-up in terms of credit and lending, and payments and cash management.

Alastair Ryan

I have one question regarding ring-fence, please. The concept of the ring-fenced bank seems quite alien to HSBC. So you're going to do it, because you're asked to.

But the concept of the ring-fenced bank seems to be that, in a moment of crisis, that the independent Board will pull the plug on any relationship with the Group, and it always struck me that HSBC is designed to be financially obviously strong at that exact moment, so the ring-fence is quite the opposite of what you're built to be. And then you're going to rebrand it as well, which is not characteristic of the Group, unless you've half an eye on not owning it down the road. If you can't get comfortable with the PRA [Prudential Regulatory Authority] and the FPC [Financial Policy Committee] and the parliamentary committees and that, in that moment of crisis, it won't pull the plug – I'm just trying to think through that. You sounded a bit more comfortable this time than last time. It's not obvious why you would be more comfortable at this point.

Iain Mackay

So our principal concern around the independence of the ring-fenced bank is: what does independence mean? What the PRA has endeavoured to impress upon us is that independence doesn't mean they can act unilaterally. It does mean that, strategically, the ring-fenced bank should be connected to the Group; that, logically, the CEO of the ring-fenced bank should report to the CEO of the Group, whilst also being accountable to an independent Board; and that, yes, the ring-fenced bank Board should be answerable for adhering to the strategy of the Group and paying dividends in line with Group policy. What the Board cannot do, and what the Group could not impose upon the Board to do, is break UK law. So, for example, we could not impose upon the ring-fenced bank to undertake activities which are proscribed by law.

That's the way, it's been articulated to us in conversation with the PRA. It would be helpful to get some of that clarification in a more solid paper-and-ink form at some point, but, at the same time, with an eye to a changing environment, which could be either for the better or for the worse, we are structuring simply to afford some optionality for the future. However, to try to be as clear as possible, this is a business which – assuming that we as an industry can get past customer redress and fines and penalties multiple times over for the same misconduct on foreign exchange – it is an underlying attractively profitable business that historically has paid a strong dividend flow to the parent company and we think the construct, as a retail and commercial banking business, can be a very competitive and effective business in the UK, and it should be a good market for it.

So it will come down to – how attractive that is for the Group. It will come down a little bit to one of the earlier conversations around: what are the capital, TLAC leverage requirements that are set, which then would inform the returns that could be achieved, which would inform dividends that could be paid, and the strategic importance and relevance of it to the Group. Although the rebranding discussion is not ready for public consumption yet, the approach to that is– quite logical, I would think – conversation with employees; conversations with our customers about how we need to differentiate it to the rest of the Group. You need to know you're dealing with the ring-fenced bank, but how do we differentiate it – what you as customers think about this, and, frankly, as employees, what do you think about this?

So our marketing team, led by Chris Clark, is doing that work, and that'll all be wrapped up in, hopefully, if not the third quarter, certainly by the end of the year. I'm sure Stuart or the European Board will inform the market about how we're going to rebrand it.

Shailesh Raikundlia, BESI

It's just a point of clarification on the Brazilian sale. You said there's about 50bps improvement in the Core Tier 1 ratio. Is that right to assume that it's mostly on the RWA reduction – because you sold it for $5.2 billion; equity is about $3.7 billion; but then you have a negative OCI [Other Comprehensive Income], which will come through in the P&L next year, so is that a pretty fair assessment, that it's mainly RWA reduction?

Jane Leach

$37 billion of RWA reduction and about $2 billion of capital gain.

Shailesh Raikundlia

But does that come off with the OCI?

Jane Leach

You've got some OCI movements, and you've also got goodwill, which we're currently having to write off for capital purposes, so that, therefore, you no longer have that write-off to do. We've also got deferred-tax assets that we no longer have to write off for capital purposes. So there are various parts to that.

Shailesh Raikundlia

So its $2 billion net on the numerator, basically.

Jane Leach

Yes.

Shailesh Raikundlia

Okay, fine, and, just on the costs, again, so you're basically not changing your target for $32 billion is what you're saying, right – because there was a bit of confusion. Okay, thanks.

Iain Mackay

Yep, so, just quarterly, we'll say, depending on what's happening in the FX space, we'll keep constant-currencying that so people know what the exit rate for 2017 ought to be and what we're tracking to.

Raul Sinha

But you should think about it [inaudible], because the levy is going down every year.

Iain Mackay

Yeah, but my corporate tax rate's gone up 8%.

Raul Sinha

But that's not in the cost line.

Iain Mackay

No, it's not in the cost line, but –

Raul Sinha

But the levy is.

Iain Mackay

Yeah, but it's not coming off that fast.
There's nothing coming off in 2015 – nothing. 2016 – couple of basis points. It all helps. Directionally, it's good, from our perspective, but we actually don't get any benefit that feels material for the Group until 2021, and at the bottom line, after tax – and I know – trying to get our guys to think about after-tax number is nearly impossible, but after tax is what pays dividends, and that's actually what builds the capital base for the firm, but, after tax, the bank levy and the 8% corporate surcharge for banks, it's pretty much neutral through until 2021.

Manus Costello, Autonomous

Iain, you mentioned conduct costs just then. I wonder if you can give us an update on how you see PPI developing and, more broadly, you mentioned the Plevin case in the notes to your accounts. Can you give us a thought on how concerned you are about the implications of that for the industry more broadly than just PPI [Payment Protection Insurance]?

Iain Mackay

At the risk of boring you to death, our PPI approach has remained very consistent for the last – for as long as PPI's been a feature of the financial landscape for us, and that has – it's been informed by claims flow, uphold rates and payment rates. What we witnessed through the first half of the year was stable to declining claims flow, as has been the case for about the last four-five quarters; very stable uphold and payment rates. We have about 18 months' worth of coverage in our provision. That's remained consistent.

There are a number of factors that could influence claims flow, one of them being Plevin. So the Financial Ombudsman Service has slowed down dealing with certain claims that have been referred to it, because we understand they're waiting for some interpretative guidance from the FCA [Financial Conduct Authority] in terms of how they should reflect on Plevin in terms of dealing with claims. There's obviously a relationship, because they tie back to PPI, but one of them's got to do with commissions on those premiums and the other one's got to do with the nature of the premium in the first place. So our provision this half has been informed by claims flow, and that claims flow has been stable to slightly decreasing.

If the Financial Ombudsman Service takes a view on how it's going to deal with the claims that are sitting in a backlog with it just now, that could result possibly – hopefully not – in an increase in claims in the second half, but we'll – we monitor that on a monthly basis.

As for Plevin, we obviously have done analysis around what this means for the premiums associated with those products. I think the Plevin case was decided around a trigger point of about 68% premium on PPI, I believe it was. It was a bit higher than that. So, in our population, we have no commissions as high as that within our population – none. When you start moving down through the 60s, we start having some commissions around that level, but the numbers in terms of redress impact are still quite low for us. When you start getting below 60%, the numbers start becoming more material, but, on the basis that Plevin was decided round about the 68-70% mark, if that were to be applied consistently across the industry, the population, then our view is that this is not an issue for us. For the industry, given the amount of energy around this in BBA discussions, we're maybe in the minority.

Manus Costello

Do you think that energy is being expended just on PPI, or do you think people are worried that it might apply to other products – consumer finance, etc.?

Iain Mackay

That's a good question, Manus. As far as I know, it's focused on PPI, presently.

David Lock, Deutsche Bank

Just a quick follow-up on costs, and I appreciate you've got a number of actions in train from the first half that we should see coming through in the second half. The question really is, I mean, when I look historically at HSBC's cost performance and I try and take out the significant items and the bank levy, and I try, where possible, to adjust for FX, the second half has almost always seen higher costs than the first half, and, really, the divisions which have missed have been GBM and Other. I just wondered if you can give any colour around what was the problem in those divisions historically and whether the actions you're taking are really trying to stop that lumpiness of costs coming through in the second half, when really it should be a bit smoother.

Iain Mackay

Yeah, your historical observations are accurate. So, on Other, I'll simply make a reference to some of the actions which will perhaps sound rather mundane, but, from an accounting perspective, I think our experience over the last four years is that there was a bit of a tendency – a rather old-fashioned tendency – to do house-clearing in the fourth quarter of the year, and everybody suddenly found invoices on their desks that hadn't been accrued and stuff like that. And, frankly, over the last four or five years, we've kind of tried to thrash the living daylights out of our operation teams to make sure that we've got a monthly closing process which accurately reflects or eliminates the need to do any fourth-quarter housekeeping, from an expenses and accruals management perspective, and that has progressively improved over the last couple of years.

There is, in the fourth quarter, usually an adjustment either up or down around variable comp, as we see what the final year looks like and as we go through the remuneration committee process, and that rounding is usually most influential on the Global Banking and Markets business, because that is the business that consumes the largest proportion of variable compensation within the firm. And the other aspect is – not about the absolute number on the cost line, but more about the cost-efficiency ratio and jaws – is: I have never seen a quarter in Global Banking and Markets where there's no seasonality included for the fourth quarter. We expect seasonality in the fourth quarter of this year. We've made allowance for it, and now it's a question of how much seasonality we see in the fourth quarter.

David Lock

Okay, so is it fair to assume then, given that seasonality that we would all expect in the fourth quarter, that, really, to hit the kind of cost number, really there's a lot of actions that should be coming through in the third quarter, so, by third quarter numbers, really we should see a lot of the kind of things you're talking about from the first half coming through next quarter? It's not a back-ended just to the fourth quarter, on the cost side.

Iain Mackay

Third and fourth.

Arturo de Frias Marques, Santander

Back to risk-weighted asset growth, I think you mentioned in the call that some people had been confused and thought that all the risk-weighted asset growth would be in Asia. I was probably one of them, so I'm going to ask you… Talking about the $150 billion part which you are more convinced about, is that going to be mostly Asia? I'm trying to figure out what is organic growth that you are implying with your RWA reallocation strategy. If I look at Asia's RWAs, which are around $490 billion, growing $150 billion is around 30%, and that implies about 10% annualised organic growth. Is that a fair way to look at it?

And then a second question on ratings, talking about the ring-fenced bank and the non-ring-fenced bank, I assume that the ring-fenced entity is going to have a fairly strong rating, given the 15% core tier 1 and 5% leverage ratio that you mentioned, but what about the non-ring-fenced entity? Do you expect any volatility on the ratings of the non-ring-fenced, because of capital reallocation within the Group?

Iain Mackay

Let's try and sort out a couple of misconceptions there, okay? I'm not suggesting that the ring-fenced bank is going to have 15% common equity tier 1 and a 5% leverage ratio. They were used purely as examples. That is not our expectation, right? So take those out of your models and do not rely on them.

Arturo de Frias Marques

Okay.

Iain Mackay

Secondly, at no point did either Stuart Gulliver or myself or anybody else say that all of our growth was going to be in the Pearl River Delta or Asia. Of the $150-180 billion of redeployment, we would expect the majority – namely 50%, thereabouts – to be focused on ASEAN; China; within China, Pearl River Delta, and the balance to be across our Middle East, European and North American businesses, and principally to be across the Commercial Banking businesses and the Retail Banking and Wealth Management, with the lion's share probably in the Commercial Banking business. So, no, if you take $150 billion as a number, we will not be redeploying $150 billion into Europe or $150 billion into Pearl River Delta, but probably somewhere in the region to 50-55-60% of that, which would be entirely consistent with the growth rate in Asia, slightly ahead of it, but consistent with the growth rate in Asia over the last two or three years.

Arturo de Frias Marques

That was going to be my follow-up. That's basically growing in line with the market, or with the economies.

Iain Mackay

Yes.

Arturo de Frias Marques

Okay. Back to the ratings question, I take your point; I'm not going to assume 15% core equity tier 1 for the ring-fenced entity. What about the view on ratings for the non-ring-fenced entity?

Iain Mackay

Again, you know, I think that's a great conversation to have with the rating agencies, but our view is that the ring-fenced bank, if anything, may suffer from a slightly weaker rating than that of the non-ring-fenced bank, given the fact that it is independent, presumably, and therefore the whole purpose, legislatively, of its existence is that it does not depend on Group support, whereas the non-ring-fenced bank presumptively would depend on Group support, or presumably would have a slightly stronger rating. But that's sort of the theory of the case that we're following, and I think it's a worthy conversation with the rating agencies.

Arturo de Frias Marques

Because that might have an impact on the business model of GBM. I mean, different ratings – lower ratings than the current ones would make it more difficult to pursue some of the business lines that you are pursuing now, so it might have an additional impact on revenues.

Iain Mackay

Yeah, but GB&M is not in the ring-fenced bank, Arturo. It's in the non-ring-fenced.

Arturo de Frias Marques

No, that's what I meant – being in the non-ring-fenced bank.

Iain Mackay

And we expect the non-ring-fenced bank to have a stronger rating than the ring-fenced bank.

Arturo de Frias Marques

Okay – because of the Group support.

Chintan Joshi

The $140 billion in GBM, $40 billion is legacy credit. I'm just wondering, in the capital finance and trade finance piece, how much came out in the first half and then in model changes. There were three pieces in GBM – $40, $60, $40 billion. I'm just trying to get… So $14 billion out of the legacy credit…

Iain Mackay

So $14 billion was legacy.

Chintan Joshi

Out of the model changes, how much?

Iain Mackay

So we had refined measurement – so collateral was $6 billion, so that was just better collateral matching, and then, from data actions, which is principally around data granularity improvement, was about $3.5 billion, and then measurement, which was modelling, was about $7 billion.

Chintan Joshi

So $7 billion from $40 billion, and the two go in the $60 billion?

Iain Mackay

So we had a total of $31 billion in Global Banking and Markets: $14 billion from legacy, $7 billion from modelling, $6 billion from collateral and $3.5 billion from data clean-up.

Chintan Joshi

Can I get your commodity exposure in Asia?

Iain Mackay

Peanuts.

Chintan Joshi

Brilliant, thank you.