Edited Transcript

Interim Results 2015

Presentation to Investors and Analysts

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Corporate participants:
Douglas Flint, Group Chairman
Stuart Gulliver, Group Chief Executive
Iain Mackay, Group Finance Director

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HSBC

Douglas Flint, Group Chairman

Good afternoon from Hong Kong; good morning to everyone in London; and welcome to the 2015 HSBC interim results conference call. With me are Stuart Gulliver, Group Chief Executive; Iain Mackay, the Group Finance Director; and Peter Wong, the Chief Executive of Asia-Pacific.

Before I hand over to them, I'd like to say a word on behalf of the Board. We've had an encouraging start to 2015, with the interim results once again demonstrating both the resilience and the balance of HSBC. Particularly encouraging was the revenue growth from areas that we've been investing in to offset the understandable decline in revenues from our run-off portfolios and divestments. Board oversight of management is now tightly focused on the delivery of the actions set out at the Investor Update on 9 June, and management performance scorecards have been adjusted to reflect this. Stuart will update you on progress to date, which is very promising.

Our positioning across the major trade and investment corridors of the world is a privileged position from which to plan our future. We have the financial strength and the right people at all levels of the firm to make the most of the opportunities open to us, and we look forward to reporting on our progress.

I'll now hand over to Stuart to talk about the context around our results, before Iain takes a more detailed look at performance. Stuart.

Stuart Gulliver, Group Chief Executive

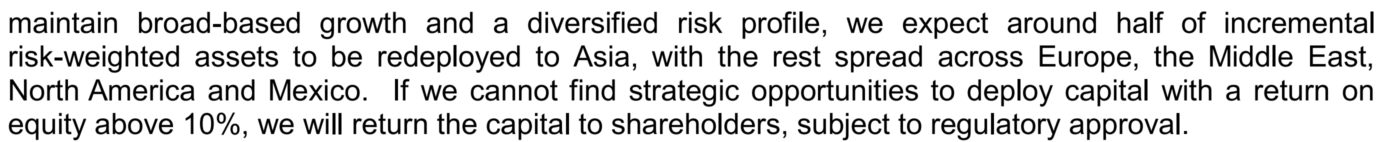
Thanks, Douglas. So let me start by pulling out a few highlights and providing a quick update on the actions we set out at our investor update on 9 June. So, as Douglas said, our performance in the first half of 2015 demonstrated the strength of our diversified universal banking model. Reported profit before tax for the first half of the year was 10% higher than in the first half of 2014, and adjusted profit before tax was up by 2%. The increase in adjusted profit before tax was driven by Asia, which contributed more than 60% of Group PBT in the first half of 2015. In Global Banking and Markets, revenues were 10% higher than in the first half of last year, following strong performances by Equities and by Foreign Exchange. Revenue also increased in both Commercial Banking and Principal Retail Banking and Wealth Management, with growth particularly focused in Hong Kong. There was a 6% increase in revenue arising from cross-selling between our global businesses.

Operating expenses were up, as we expected, although, excluding the bank levy, costs remained broadly consistent with the second half of last year. Our return on equity was 10.6%, and we further strengthened our common-equity-tier-1 ratio to 11.6% and declared dividends per ordinary share of 20 cents for the first half of the year.

Now, it's less than two months since our investor update, where we unveiled our actions to capture the value of our international network in a changed world. Executing those actions is our number 1 priority. Work is proceeding in all of these areas, in particular those aimed at reducing risk-weighted assets, cutting costs and turning around or disposing of underperforming parts of the business. Our first action is to reduce the Group's risk-weighted assets by about $290 billion, around half of which will come from resizing of Global Banking and Markets. In the first half, targeted actions reduced $50 billion of risk-weight assets, $31 billion of which came from Global Banking and Markets. The majority of this reduction occurred in the second quarter, as we accelerated our RWA-reduction programme.

And, as you will know, we've announced this morning that we have agreed to sell our Brazilian business to Banco Bradesco for $5.2 billion. This is a major transaction that delivers excellent value for our shareholders and represents significant delivery against the actions we outlined in June. As we said at our investor update, we plan to maintain a modest corporate banking presence in Brazil to serve our international clients.

Over the next two years, we'll continue to build our capital base and redeploy some of the risk-weighted assets that we take out of the business, in line with the priorities we outlined at our investor update. In the first half of the year, we redeployed $22 billion of risk-weighted assets into higher-returning areas of the business; that's excluding associates. Although we are aiming to pivot our business towards profitable growth opportunities in Asia, Asia is not the exclusive focus of reinvestment. In order to



maintain broad-based growth and a diversified risk profile, we expect around half of incremental risk-weighted assets to be redeployed to Asia, with the rest spread across Europe, the Middle East, North America and Mexico. If we cannot find strategic opportunities to deploy capital with a return on equity above 10%, we will return the capital to shareholders, subject to regulatory approval.

The revenue increases that we've seen in our priority product areas in the first half of the year demonstrate the impact of the investment that we've made so far and give a sense of the revenue opportunity that our international network provides. In total, there was an 8% increase in revenue from transaction banking products in the first half of the year, which again illustrates the value and the potential of our international network. In particular, Foreign Exchange revenue grew by 21% and Payments and Cash Management revenue increased by 4%. We also maintained our leadership position in international renminbi services, growing revenue by 9% compared to the first half of 2014. Our priority for the remainder of 2015 is to make significant progress in executing all of our actions, and we'll provide an update on each action when we announce our third quarter results in November. Iain's now going to run you through the results in detail.

Iain Mackay, Group Finance Director

Great, thanks, Stuart. For the first half, reported profit before tax was $13.6 billion, up 10% on the first half of 2014. This includes an increase in the provisions for fines and settlements relating to foreign exchange investigations in the US and Europe of around $800 million. Adjusted profit before tax was $13 billion, up $280 million, or 2%. You'll recall that the adjusted measure excludes the in-period effects of foreign currency translation differences and significant items, and you'll find more detail on these adjustments in the appendix to the presentation.

Looking at some key metrics, the annualised reported return on average ordinary shareholder's equity was 10.6%. The annualised reported return on average tangible equity was 12%, and, on an adjusted basis, we had negative jaws, which was largely in line with our expectations for the first half of this year, and our common-equity-tier-1 capital ratio on an endpoint basis was 11.6%.

This slide shows the breakdown of the profit before tax for the first half and comparable period last year, split by global business and by region. The figures shown are on an adjusted basis. As you can see, on the right of the slide, the increase in profit before tax was driven by Asia, where revenue increased across all global businesses. Revenue was up 10%, notably in Hong Kong, from Wealth Management products and client-facing Global Banking and Markets. Operating costs also increased.

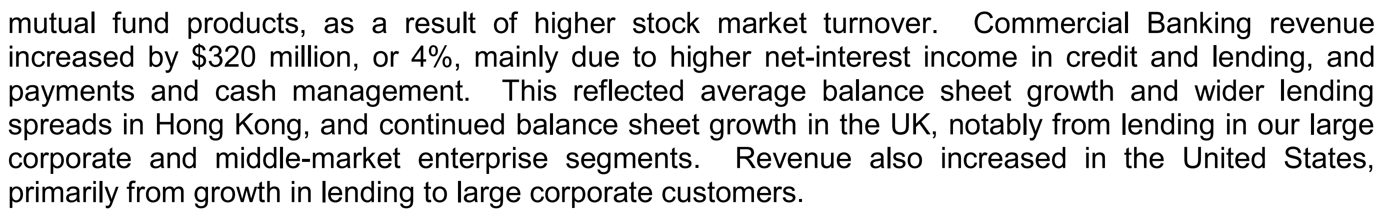
In Europe, profit before tax was lower, due to increased operating expenses from regulatory programmes and compliance. However, revenue increased by 4%, driven by client-facing businesses in Global Banking and Markets, and balance sheet management.

In North America, profit before tax was lower, driven by lower revenue and higher costs. The principal driver of lower revenue was the continued run-off and loan sales in the CML portfolio. Our continued investment in Commercial Banking and Global Banking and Markets resulted in growth in loans and advances, creating the basis for higher revenue in the future.

Profit before tax increased in Latin America, due to higher revenues and lower loan impairment charges. Revenue was up by 2%, primarily in Commercial Banking. Loan impairment charges were down in Retail Banking and Wealth Management in Brazil, due to the non-recurrence of charges relating to model changes in the first half of 2014, and in Mexico, due to lower collectively assessed impairment charges.

In Middle East and North Africa, profit before tax of $899 million was 8% lower than in the first half of 2014, due primarily to an adverse movement in loan impairment charges. This was caused by individually-assessed impairment charges in the first half of 15, which contrasted with a net release in the same period last year, mainly on United Arab Emirates-related exposures in Commercial Banking and Global Banking and Markets. As we go through the rest of the presentation, we'll talk through global business performance in more detail.

This next slide shows an analysis of adjusted revenue. Revenue in principal Retail Banking and Wealth Management was $472 million higher, an increase of 4%. This was driven by higher revenues across all Wealth Management products, but especially in Hong Kong, from investment distribution in equities and



mutual fund products, as a result of higher stock market turnover. Commercial Banking revenue increased by $320 million, or 4%, mainly due to higher net-interest income in credit and lending, and payments and cash management. This reflected average balance sheet growth and wider lending spreads in Hong Kong, and continued balance sheet growth in the UK, notably from lending in our large corporate and middle-market enterprise segments. Revenue also increased in the United States, primarily from growth in lending to large corporate customers.

In Global Banking and Markets, revenue from our client-facing businesses and balance sheet management increased by $1 billion. Our client-facing businesses recorded double-digit growth, having performed consistently well throughout the first six months of the year, especially in markets. Equities and foreign exchange were the principal drivers of growth, thanks to increased client flows in equities and increased volatilities in foreign exchange. Credit revenue also rose, due to increased client flows, and we recorded strong growth in payments and cash management, and securities services, due to increased balances across both business lines. Balance sheet management revenue was up by $290 million, partly due to increased gains and the disposal of available-for-sale debt securities. Global Private Banking attracted net new money of $7 billion in the first half of 2015 in areas that fit our targeted model, 45% of which came from working closely with other global businesses. Global Private Banking revenue was broadly unchanged.

This next slide shows the largely sustained growth in our customer lending over the past 12 months, a period in which we've continued to run off the CML portfolio. On the constant-currency basis, and excluding Brazil and the effect of red-inked balances, lending increased by $22.4 billion in the first half of the year, with growth in Asia, North America and Europe. More than half of this growth took place in Asia, where term lending to customers in Global Banking and Markets and Commercial Banking increased. Balances also grew in North America by $5 billion, driven by increased term lending to corporates and commercial customers in CMB and Global Banking and Markets. In Europe, a $3 billion increase of loans and advances was primarily driven by higher term lending in Commercial Banking, mainly in the UK and Germany. Customer accounts increased by $28.8 billion, and we continue to have a strong leverage ratio, which now stands at 4.9%.

As you know, we set out a strategic target at our investor update to deliver 2017 exit run-rate costs at the same level as 2014. Operating expenses in the first half were as we expected at this point. Adjusted operating expenses increased by $1.2 billion compared to the first half of 2014. This reflected increases in both run-the-bank and change-the-bank costs. Front office run-the-bank costs increased by $579 million, or 8%. This reflected a targeted increase in the number of staff employed to support growth initiatives. We also experienced wage inflation, principally in Argentina, Brazil and Hong Kong. The main targets for growth investment included Retail Banking and Wealth Management in Asia and payments and cash management in Global Banking and Markets and Commercial Banking. Stuart has already talked about the revenue benefits that we've started to see from this kind of investment.

Back office run-the-bank costs increased by $244 million, or 3%, reflecting our ongoing focus on global standards. Change-the-bank costs increased by $383 million, or 28%, mainly due to higher regulatory and compliance costs. These included the group-wide rollout of the new AML and sanctions policy procedures, and the ongoing parallel deployment of customer due diligence and financial crime compliance infrastructure. It's worth noting that, although our adjusted costs are up compared to the first half of 2014, they're broadly flat compared with the second half of 2014, excluding the bank levy. And, as Stuart's already said, we're moving forward with our plans to remove $4.5-5 billion of costs from the businesses.

Adjusted loan impairment charges were down by $133 million, or 8%, compared to the same period in 2014. The ratio of loan impairment charges to average gross loans and advances to customers fell to 30bps from 33 in the first half of 2014. This was mainly due to much lower loan impairment charges in North America and Latin America. Loan impairment charges continue to remain low, which relates directly to actions that we took in 2011 and 2012 to reduce risk within our credit portfolio. This means that we operate with a much lower loan-impairment-charges-to-loans-and-advances ratio than our peers, and it means that we've a significant risk-appetite capacity.

North America loan impairment charges were $252 million lower, reflecting reduced levels of new impaired loans and delinquency in the CML portfolio, as well as lower lending balances from the

continued run-off and loan sales. In Latin America, loan impairment charges fell by $73 million, due mainly to lower collectively assessed impairment charges in Retail Banking and Wealth Management, in both Brazil and Mexico.

And loan impairment charges increased in the Middle East and North Africa, Europe and Asia. In the Middle East and North Africa, the increase reflected individually assessed impairment charges in the first half of 2015, compared with a net release in the first half of 2014, primarily in the United Arab Emirates related exposures in Commercial Banking and Global Banking and Markets. In Europe, we recorded $92 million of impairment charges related to Greek exposures and saw lower releases of impairments in available-for-sale asset-backed securities. Loan impairment charges increased in Asia, mainly due to a specific impairment charge in Commercial Banking in Indonesia.

Turning to capital, the Group's endpoint common-equity-tier-1 ratio increased to 11.6%, against 11.1% at the end of last year, reflecting capital generation and risk-weighted-asset initiatives. Risk-weighted assets were redeployed through business growth in the period, and we also absorbed the impact of regulatory changes. We generated capital of $5.6 billion from profits, net of dividend. This also included the benefit of higher dividend scrip take-up. After adjusting for the effects of foreign-currency translation differences, we reduced risk-weighted assets in the period, through targeted actions.

This next slide looks at the risk-weighted assets in more detail. At our investor update, we set out our intention to reduce risk-weighted assets by $290 billion from year-end 2014. In the first half of this year, we've already reduced risk-weighted assets by $50 billion, through targeted initiatives. The majority of this reduction came from Global Banking and Markets, where we realised savings of $31 billion. This comprised $14 billion from legacy portfolio disposals and $17 billion by increasing the level of detail in our risk-weighted assets calculations. The partial sale of our shareholding in Industrial Bank reduced RWAs by $12 billion in the period. Excluding associates, $22 billion has already been redeployed into higher-returning areas, primarily in corporate lending across Commercial Banking and Global Banking and Markets.

This next slide shows our Group-return metrics. The annualised reported return on average ordinary shareholder's equity was 10.6%, which is significantly higher than at the end of 2014. The annualised reported return on average tangible equity was 12%. On a reported basis, return on risk-weighted assets was 2.3%, compared to 2.1% in the first half of 2014. Adjusted return on risk-weighted assets, which excludes significant items, remained broadly flat in the first half of 2015, due to comparable movements in risk-weighted assets and profit before tax. In summary, whilst it's early days, our programme to reduce risk-weighted assets is progressing well, and we continue to work towards our adjusted return on risk-weighted assets target of greater than 2.3% by 2017.

And, with that, let me hand back to Stuart.

Stuart Gulliver

Thanks. So we'll now take some questions. So the operator will explain the procedure and then introduce the first question.

Alastair Ryan, Bank of America

Thank you. Thank you, good morning. On net-interest income, if I may, please, the Group's very strong positive leverage to higher rates is a key feature, but, in the short term, while we're waiting for Yellen to deliver, there is still a bit of downward pressure on the net-interest margin – a couple of basis points off in the first half – will that go down again before it goes back up? And then, secondly, on the very strong areas of outperformance in the first half, the layman would infer that – or would assume that FX revenues picking up should be sustainable; we're in a complicated world, and that's a key part of the business, but then the question probably is, on the equities and related insurance gains and Wealth Management sales, whether the first half there is indicative of an ongoing picture or, given the moves in the Chinese stock market over the last few weeks, whether the first half was a bit of a high-water mark. Thank you.

Stuart Gulliver

So Iain will do the net-interest income. I'll take the other.

Iain Mackay

Okay, so I'll start. On net-interest margins, you're right; we came about 3bps off compared to the first half of last year, in net-interest margin. Couple of things driving this in that particular area: North America – again, the continued run-off of the CML portfolio. Another factor was in Europe, where we saw a bit of yield pressure coming through UK mortgages. I think that's probably broadly understood as a fairly competitive environment, and it is driven by the yield on the asset base, whereas, from a cost-of-funds standpoint, it remains very consistent across the European market. And we also saw a little bit of pressure coming through policy rate changes in countries like China and Brazil, for example.

In terms of whether there's continued pressure, I think we continue to pursue fairly aggressive growth on mortgages within the UK. It's a competitive environment, but I think we see, particularly within the segments that we serve, a reasonable stability around mortgage pricing in the UK. North America – we're going to continue to see some pressure from run-off in CML, but that obviously is becoming less and less influential over time. Brazil will continue to play a focus, at least until we get through to completion of the transaction that we announced today. But, broadly speaking, as you would imagine, there's lots of movements coming through Balance Sheet Management and various businesses, but the dilution that we see is pretty marginal and the teams are certainly very focused on taking pricing opportunities where they see them.

Stuart Gulliver

So I think your assumptions around FX and equities are broadly correct. So foreign exchange – yes, if we have continued increased volatility, there's no reason why FX should have a significant deterioration in revenue going forward, although obviously it won't increase at 27% per quarter per quarter. As for equities, yes the first half of this year – or the first quarter of this year was very much benefited by the Hong Kong-Shanghai Stock Connect and significantly increased volumes running through that, which shows up both in the equities line; also it shows up in Private Banking – shows up also in securities, custodian and in Retail Banking and Wealth Management in Hong Kong. And obviously the sharp fall in the Chinese stock market has depressed some of that activity, but not all of it. The volumes that are still going through the Hong Kong stock market are still considerably higher than a year ago, so I'd expect that to be sort of muted, but not a complete reversal at all.

Alastair Ryan

Thank you.

Stuart Gulliver

Thanks, Alastair. Next one, please.

Chintan Joshi, Nomura

Hi, good morning. I've got two, please: one on FX and one on RWAs. On FX, I see you've taken a $1.3 billion provision. I just wanted to get a sense of how close you are to settling this. Should we expect a further top-up? You know, the total provisions there – are they sufficient at this stage? That's the first one, and the second one is: quite a strong run-down of RWAs, especially if you consider Brazil. I just wanted to get a sense of that $290 billion target that you gave us – obviously there's a lot of FX noise from quarter to quarter. I just wanted to get what the FX-adjusted number would be at this stage, and, in Brazil I think you had given us a 50/20 split; I'm just trying to work out how should I think about the $37 billion relative to that 50/20 split in Brazil and Turkey that you've given us. Thank you.

Iain Mackay

Okay, thanks, Chintan. On the FX provision, in the first half, there was just under $800 million provided as it related to foreign exchange matters, and that covers a number of investigations that are underway, either by the Federal Reserve, the OCC, the DOJ in the United States, relating to progress that we're making on settlement in a range of class-action suits in the US, again with respect to FX, and matters which the European Commission are considering. When you take that provision along with what was provided in 2014, we now have a total that has either been provided and/or settled of just under $2 billion, broadly relating to the same issues in the foreign exchange space.

As to the ultimate outcome of that, they are investigations that are ongoing and settlement discussions that are ongoing. We've made – as you would expect – provision for what we reasonably expect to anticipate in terms of cash outflows to settle those matters. It goes without saying that we'll keep you posted if there are further developments in that space, and, as ever, there's a fairly decent amount of detail about how progress is being made in note 19 to the interim report around these matters.

On RWA reduction, it was absolutely a good start for the first half of the year in terms of managing down RWAs – good progress, clearly more to do. In terms of the real impact from FX on RWAs – not really material through the cycle, so I'd keep a focus on the $290 billion numbers if I were you. The sale of the business in Brazil – excluding operational risk RWAs – accounts for $37 billion of RWA reduction. Including notionals, it takes it up to about $48-49 billion.

Chintan Joshi

Just as a follow-up, are we close to settling FX in the coming months, and that op risk – when can we expect that to fall off?

Iain Mackay

So the op risk will start to fall away as the transaction is closed, but it takes three years for it to disappear in its entirety. So an analogue for this would have been the disposition of our credit cards portfolio in the US, and the op risk – you know, we're into the last year of that op risk now falling away in the US, and it'll be the better part of three to four years before we see all of that falling away in the Brazilian transaction. As for foreign exchange, Chintan you know, that one sits with the people on the other side of the settlement. One good example of it – and, again, this is disclosed in note 19 – there were agreements reached with the DOJ and other authorities in the US, with, I think, five or six other participants in the first half of the year. We were not part of that settlement and had not been approached for part of that settlement. We are working on the reasonable assumption that we will be approached at some point by those authorities to enter into settlement discussions round it, but, as to the exact timing or the exact outcomes, not really within our power to drive that one.

Chintan Joshi

Understood, thank you very much.

Stuart Gulliver

Thank you, thanks, Chintan. Next, please.

Chira Barua, Sanford Bernstein

Hi, guys. Just a very quick question on the interest rate sensitivity and actually the timing of it: if the US – what I'm trying to understand is, if the US goes ahead in September and does 25bps, we know the sensitivity. It would be great if you can help us understand what's going to go through your Q4 numbers, all is equal, both in terms of mark-to-market losses as well as gains. How quickly can it flow through your deposit book?

Iain Mackay

Yeah, look, assuming the Fed did something in the fourth quarter, the likelihood of seeing any real impact in the fourth quarter is very, very small. This reprices through the book progressively, so the likelihood – you know, if you get something on 1 October, the likelihood of your seeing a significant impact on fourth quarter numbers, either in terms of mark-to-market or net-interest income – it will phase in over time, so you're not going to see a major impact in the fourth quarter. We would, of course, expect to see an impact coming through over the succeeding quarters as that gets priced across our books of business.

Chira Barua

Thanks.

Stuart Gulliver

Okay, next, please.

David Lock, Deutsche Bank

Good morning, everyone. I've got two, please. First one is on cost: this was a small miss, I think, versus what consensus was looking for, and I note the negative jaws in the first half, which you say are kind of in line with what you'd been planning, but I also recall at the investor day you were trying to target positive jaws in 2015, 16 and 17. So I just wondered if there was anything we could infer from that about the second half, because, typically, the revenue performance is obviously a little bit weaker in GBM in the second half of the year, so what can we infer from that around costs in the second half?

And then the second one is around risk-weighted assets. I just wondered if you can give us any colour on where within GBM those risk-weighted assets have been coming out. Thank you.

Iain Mackay

So, if I take the RWA one first, there was – let me see, one second – we had a total of $50 billion coming out in terms of RWA initiatives. Within GB&M, $31 billion came out. $14 billion came from the sell-off of legacy ABS positions. $7 billion came from refined measurements, so enhanced data granularity coming through. About $6 billion came from improved collateral set-off on transactions, and then a few other smaller numbers came through broadly from improvements in data quality. So that's the round from Global Banking and Markets. As it related to the disposition of the legacy ABS portfolios, as Samir had mentioned at the investor update, the P&L impact of that was largely neutral. There was, in actual fact, a very, very small gain realised on disposition of those positions, and then, as you came imagine, across the other areas of RWA improvement within Global Banking and Markets in this half, given the nature of them, there was no real revenue or P&L impact coming through on that.

The other main areas of RWA reduction – the partial disposition of the Industrial Bank stake held by Hang Seng contributed about $12 billion of RWA reduction, and then we had a further $5.2 billion of reduction in the US CML portfolio, and that's coming through both the continued improving performance of the portfolio, as well as the continued run-off of that portfolio in the normal course of business, and in addition to one transaction in the first half, which was a portfolio sale of about $500 million in unpaid principal balances. So that's broadly the breakdown. You'll come up with about a $2 billion difference, and that was coming through CMB, across a broad range of actions. So that's the meat and potatoes, if you like, in RWA reductions.

On costs for the second half, as Stuart, Andy and I said at the investor update, we're targeting positive jaws for the full year – absolutely cognisant of the fact that that presents a significant challenge for the business, but that is what we're targeting for the second half of the year. And, I think as we'd mentioned on 9 June, before even getting into the $4.5 - $5 billion, which is clearly a significant part of our focus, the plan for 2015 did envisage a significant loading of cost-saving initiatives in the second half. That is the focus for the remainder of the year.

David Lock

Okay, thank you.

Stuart Gulliver

Thanks. Yeah, next, please.

Chris Manners, Morgan Stanley

My first question was on the cost guidance. As I look at slide 7 and just add up the adjusted costs for the first half of 2014, it looks like we're getting to more like $35 billion versus the $38 billion I think that you'd put in as a baseline when we had the presentation back in June, so I was just trying to understand: is that $35 billion adjusted cost number there – should we be taking off Brazil and Turkey from that to get our exit rate for 2017? Just trying to work out how's the exit rate for 2017 changed, because it looks like you've got a lower adjusted cost base when I look at that slide.

And the second question was actually just trying to look at the comment I think that was made there on page 10 of the release about the capital return, if you can't find opportunities to deploy capital at an RoE of above 10%. Do you see plenty of opportunities, and so you would be very happy to be deploying capital and those opportunities are there for you, or is that comment coming in because you think there's

a risk that you might not be able to find those opportunities and we could be seeing capital return? And, if so, what would you think was a surplus? I mean, above what level of capital would you be looking to return that? Thank you.

Stuart Gulliver

Taking the second question, what we're trying to do is frame the fact that, if we're going to take $290 billion off RWAs, and we said we'd redeploy a chunk of it, and looking reasonably about how much of that could be redeployed, we think we could comfortably redeploy about $150 billion very easily, just looking at where our run rates have been. Above that number will depend on how economic performance pans out, and what we're wanting to signal is that we're going to get these RWAs down. If, actually, above $150 billion is harder to do, then, subject to us being comfortably able to fit any stress test that any central bank might apply to us – and that's the point about reference to regulatory approval – then we'll return it to shareholders. It doesn't have within it an assumption as to what the surplus is. It is merely an indication of the management decision framework that we're operating with.

Iain Mackay

On costs, Chris, you'll recall that one of the charts that we provided on 9 June gave you a remeasured cost run rate exiting 2017, which factored in foreign exchange translation and effective execution of Brazilian and Turkey transactions, to name two. As we rerun that analysis today, that adjusted cost rate exiting 2017, excluding Brazil, Turkey and the bank levy – that cost run rate would be about US$31 billion, based on current exchange rates, with those factors consistently factored through. So the same analysis as we presented on 9 June, rerun at the end of June, gives you a $31 billion cost run rate and an adjusted exit for 2017. So that's how we would encourage you to think about it, and, on a quarterly basis, as we mentioned, we'll provide you with an update, because obviously foreign exchange, as well as other factors around reshaping of the portfolio, will come into it, and, as we make progress on this reshaping, as well as obviously factoring foreign exchange, we'll update you on a quarterly basis with what that means.

Chris Manners

Thanks, so I guess that number was $32 billion when we talked back in June, so maybe that's a little bit better.

Iain Mackay

The $32 billion figure we talked about in June included the bank levy.

Andrew Coombs, Citigroup

Firstly, if I could perhaps follow up on the capital return story, you talked about anything above redeploying $150 of $290 billion might be trickier, depending on macroeconomic conditions, and that you could possibly return that capital instead. Also, I just wondered – on a point, a footnote you made on your strategy day, that you talked about your progressive dividend policy as being progressive consistent with the growth of overall profitability of the Group, predicated on meeting capital requirements. I mean, when you look at your core-tier-1 ratio now, obviously much stronger, at 11.6%, and, if you adjust for Brazil, it looks like you're already within the 12-13% range where you think you need to be, so, when you talk about returning capital, could it be that the ordinary dividend could progress faster than the profitability of the Group, or is it a case of: you take stock in a year, two years' time, depending upon where the growth opportunities are, and then redistribute it as a special dividend instead? So that would be the first question.

The second question would just be: on slide 5, you draw out the strength from Wealth Management this quarter and the revenues there. Given the market volatility you have seen in mainland China more recently, has that affected investor sentiment, and, if so, what does that mean for wealth revenues going forward? Thank you.

Stuart Gulliver

On the dividend and returning capital and the redeployment of RWAs that we recycled, it does not mean that the ordinary dividend would progress in any way other than in line with the PBT of the firm, so, therefore, it means that, if we were to find ourselves in that surplus position, it's more likely to be further down the track, and it may well take the form of either a special or share buy-backs, but we'd have to have lots of comfort that we can hit whatever stress test whatever regulator is throwing at us at any particular moment in time. It does not mean that we would stray from what we said about the progressive dividend at all, so that definitely wouldn't be the case.

And, in terms of Wealth Management, there undoubtedly was a benefit to the extremely significant increase in volumes that went through the Hong Kong stock market as Hong Kong-Shanghai Stock Connect got going. The Hong Kong market now has a higher daily turnover than the London stock market, and actually it still does, so there was clearly a benefit there. But, of course, those wealth numbers actually come from wealth activities across the world, not just in Hong Kong, so there is a limited impact that I expect we'll see in the third quarter coming from slightly reduced sentiment as a result of the sell-off in the Chinese market, but I don't think you can read that across to other parts of the world. So, yes, there was a benefit, but, no, I don't think you'll see that swing significantly from the favourable side to the adverse side.

Tom Rayner, Exane BNP Paribas

Just starting on Brazil, the first-half profit of $191 million is a bit of an improvement on last year. Is that a fair reflection of the sustainable earnings of the business going forward? Just trying to get a sense of what the earnings impact might be next year, on a full-year basis. And, on the capital impact, can you just confirm – I think you indicated 50bps. I just wanted to understand – obviously we know the RWA impact – whether you're factoring in a gain or loss on that disposal, and then I've got just a couple of other questions as well, please.

Iain Mackay

So, if we go to capital, it is in the range of 50bps that we would expect, and that depends a little bit on net-asset adjustments between now and the completion date. We would, in actual fact, expect to see, as we recycle foreign exchange gains or losses, which have previously been reflected in other comprehensive income, through income on disposition. We would expect to see an accounting loss, but there is no impact on capital from that, as it's already been included in OCI. But, broadly speaking, we would expect to see $37 billion of risk-weighted assets run-down, 50bps improvement in common-equity-tier-1, with a capital impact of approximately $2 billion.

Tom Rayner

Okay, and, just on the earnings, the $191 million – is that a fairly clean reflective number now of what that business is doing?

Iain Mackay

Yeah, I mean, as I mentioned earlier, the main driver of that, Tom, was a reduction in loan impairment charges. We've obviously seen quite a lot of remodelling and actually quite a lot of stress coming through loan impairment charges, and we saw some improvement in that respect. Broadly speaking, revenue was up slightly. Loan impairment charges were down and operating expenses were maintained reasonably consistently, so it's mostly about improving loan impairment – you know, portfolio credit quality in that book.

Obviously we run this business through to closure of the transaction that we announced today, and our focus will be in trying to improve the performance of that business as we go. It's ours until it's closed, so we're going to run it to continue to improve the profitability.

Tom Rayner

Can I just ask you one more, Iain, and then maybe a quick one for Stuart on the strategy? Your comment on the cost jaws, I think Q1 to Q2 revenue growth looks like it's held fairly stable, whereas cost growth has picked up, so I'm just wondering – to deliver this full-year positive jaws, are you expecting any

real change in that revenue progression, or is it all going to be about delivering more cost savings in the back end of the year?

Iain Mackay

The back-end plan is heavily cost-focused, and, as you'll recall from previous years, Tom, the fourth quarter in Global Banking and Markets represents significant seasonality, and that is factored into our estimations at this point. To be clear, to get from where we are, at 2.9% negative jaws for the first half, to a positive jaws number, even a marginally positive jaws number, is a significant challenge for us, but that is the focus in the businesses, going through the second half of the year.

Tom Rayner

Okay, and then, just finally, Stuart, you mentioned the Chinese stock market, I think in response to your question on GBM, and I just wondered how seriously you're taking that as maybe an indication of whether the Chinese economy as a whole is starting to slow down maybe more quickly than we thought. I was just looking at your comment at the start of the release and you're talking about the pivot towards more profitable growth in Asia, but you're also now deliberately pointing out that Asia's not the only focus for you, and it's only half of the reinvestment plans for the Group. I just wondered – is that any softening in tone regarding Asia, given what's happening in China, or is that reading, as usual, too much into everything?

Stuart Gulliver

I think that's reading too much into everything. Actually, what I'm trying to do, Tom, is clarify the fact that, on 9 June, a number of people came away with the impression that we were trying to jam $290 billion of RWAs into the Pearl River Delta, so I was trying to explain that, clearly, we're not trying to end up with a completely undiversified business model where we redeploy $290 billion into one small geographic area. So what I'm trying to set out is that nothing's changed about the fact that we believe passionately in being a global universal bank, which means diversified by business line and diversified by geography. So I wouldn't read anything into that. There was a wrongful interpretation that the entire redeployment was in Asia, because of the way we presented on 9 June, and that's what I'm trying to correct as an impression. It's not related to any feeling about slowdown in the Chinese economy from the sell-off on the stock market.

We're still reasonably confident that Chinese economic growth, actually, will be at the numbers we thought previously, and that whilst we probably haven't seen fully the impact in terms of bad debts and so on that come about from the sell-off in the stock market – which I think represents the most risk, in the sense that a chunk of this has been margin finance, to those people that provided the margin finance – we're still very much looking for 7%, 7.1% GDP growth for this year for China. So, no, that RWA comment is more about correcting a misimpression we gave on 9 June than any concern we have about Chinese GDP.

Martin Leitgeb, Goldman Sachs

Just a follow-up on the earlier question on capital formation and capital progress. Obviously, pro forma for Brazil, you have now core-tier-1 ratio, which is 12%, or a touch above. And I was just wondering if you could update us on how we should think on progress of core-tier-1 capital here going forward, in light of the potential regulatory headwinds we discussed back at Investor Day? So what do you think of that is likely to materialise over the next six, 12 months, which we should be in mind for outlook?

The second question is on taxation, and what is the right way for us to think in terms of effective tax rate going forward, post the rebased bank levy? And I'm not sure if this is too early to ask or not, but I was just wondering if you could comment on what the recently-announced changes in the budget – how they will affect the way you think of the 10 criteria you set up earlier with regards to domicile.

Iain Mackay

Okay. So Stuart will comment on – perhaps not the detail of the tax changes, which I'll cover, but how that influences our thinking about headquarters. But the taxes – broadly speaking, the direction on the tax levy is certainly very welcome from our standpoint. However, when you pair it with an 8% surcharge

on corporate tax for the banking sector, based on our forecasting, that is broadly neutral for HSBC until 2021, and in 2021, the adjustment to the basis of calculation for the bank levy certainly would give us a quite significant positive impact. However, through 2020, the levy reductions are largely offset by the impact of corporate tax in the UK.

Now, insofar as the overall group effective tax rate goes, it is to some degree, obviously, influenced by taxable profits in the UK, but the effective tax rate is also made up of profits generated in other jurisdictions which are taxed at different rates, as well as a number of disallowable items such as settlements, fines and penalties, which generally are not tax-deductible items and fall into those which are permanently disallowed. So we'll continue to guide on where the effective tax rate would be, but when the changes of the Budget click in, next year's taxable profits, we would expect to see possibly a slightly higher effective tax rate for the group, informed largely by the degree of taxable profits that we have in the UK business.

Stuart Gulliver

There's not really much to say at this stage. Obviously, the bank levy is a subset of one of the points our Board will be considering, which is the broad question of tax in its widest sense. And clearly, therefore, this is a changed fact that the Board will consider during the balance of the year while it's making its deliberation as to what to recommend to shareholders.

Iain Mackay

Going back to capital formation, Martin, yeah, I think certainly as it relates to the next six to 12 months, possibly the publication last week of the PRA's approach to the PRA buffer – Pillar 2 and the PRA buffer specifically – is more that will inform aspects around regulatory change on capital, as opposed to some of those factors that were discussed earlier in June, when we talked about the fundamental review of the trading book; the Basel review of credit risk from a standardised approach perspective; operational risk, as well. And we see those as being very active discussions presently, certainly as it relates to credit risk. The probable outcome of that from a regulatory capital perspective is very, very difficult to discern presently, and in our estimation – I think probably the market's estimation – is most likely to impact capital requirements in 2018 or even later. So our focus, certainly around target-setting back in June, was the timeframe now to the end of 2017, and as it relates to capital formation, I think the changes published by the PRA influencing Pillar 2 and, specifically, the PRA buffer – which will replace the capital-planning buffer, as we understand it – are probably the factor to consider most significantly at the present time.

When we close the Brazilian transaction, yes, we would expect to see ourselves with a common-equity-tier-1 ratio, all other things being equal, slightly above the 12% mark, which is encouraging. And then, as we go back to some of the comments that Stuart made earlier about how that then influences our view on running down risk-weighted assets, the possible return of surplus capital to shareholders, obviously sitting with a common-equity-tier-1 ratio sitting in the range of 12% to 13% will encourage and inform our thinking at that time.

Martin Leitgeb

Great. Many thanks.

Stuart Gulliver

Thank you.

Manus Costello

Good morning. I actually have a couple of questions. The first one just follows on from what you were just talking about then, Iain, about the PRA buffer and changes being important to you. Should we therefore assume that the PRA buffer is in fact binding on you at the moment? Because I'd kind of assumed that – given the capital conversation buffer and the G-SIB buffer together are 500 basis points for you, that the PRA buffer wasn't necessarily something which was a concern, but your comments just now made it sound a bit like the PRA buffer was coming into play in the way you were thinking about

capital. And my second question just relates to the sale of Brazil. You've got some ongoing litigation around savings accounts in Brazil, which has been rumbling for a very long time. I just wondered if that's going to be sold with the business as well, or if you retain that liability?

Iain Mackay

So on the buffer, your statement is correct, Manus, in the sense that the PRA buffer, as presented, would be considered alongside the other aspects of capital buffers, whether it's from a capital conservation perspective or a G-SIB perspective. There is one thing that's introduced that may apply, which is the capital scale, and, you know, that will be part of the ongoing PRA's review of each institution, and the extent to which they apply any scale, then that would then be incorporated. So we absolutely do have a Pillar 2A, Pillar 2B requirement today. That's encompassed within which we cover today, and the clarification around the PRA buffer is that, you know, it would lie alongside G-SIB and capital conservation buffer now. Whether this consultation – not the consultation, but whether the publication last week necessarily informs increased capital requirements, will depend very much on the capital management review that the PRA does of each of the institutions in the UK. So I wouldn't want you to read into it that we're automatically requiring higher capital requirements. It will be informed by capital assessments that the PRA do on an ongoing basis.

Manus Costello

Got it, thanks. And on Brazil?

Iain Mackay

Oh, Brazil. It is being sold with it, but as you'd imagine in any transaction of this nature, there are reps and warranties that go with that, and that's really how this is covered, Manus. But, yes, it is an integral sale of the Brazilian business. There is nothing that we are retaining. We will continue to have the ability to serve customers internationally in US dollars, but not domestically, and there's a non-compete that will cover domestic large corporate business. But broadly speaking, the business in its entirety is being sold, and that's reflected in the net assets and the price, but with the usual reps and warranties around the transaction.

Manus Costello

But that $700 million that you mention in the notes as a potential litigation risk from that – that resides with Bradesco now?

Iain Mackay

That exposure goes with the business.

Manus Costello

Got it. Okay, thank you.

Sandy Chen, Cenkos Securities

Morning, gentlemen. Just had one question, just for a bit more detail in GBM. If you could sort of say what the RWA relative weightings in credit and rates are, in particular? I mean, my guess is that, actually, the bulk of the $491 billion might be tied up in those types of businesses, versus the forex and equities, and if you could comment on sort of cost/income ratios and relative RoRWAs, in terms of where we might expect further pruning to occur?

Iain Mackay

I don't have that relative weightings of those businesses in front of me, Sandy, so sorry, I can't necessarily provide you with that information right now.

Stuart Gulliver

There was a bit of detail, though, in Samir's presentation that we did on 9 June, which actually shows a walk of where the RWAs will come down. So there's a RWA walk on the deck that Samir talked to on 9 June, Sandy, that's on the investor website.

Iain Mackay

Page 28 in the investor deck that Samir presented, it gives you some relativity around the adjusted returns that we're focusing on in Global Banking and Markets, from a return on risk-weighted assets perspective, Sandy. And as it relates to particular guidance around cost efficiency ratios, not really a measure we're dealing with externally; the focus is on positive jaws, and that continues to be the focus.

Stuart Gulliver

And, actually, the cost efficiency ratio of Global Banking and Markets is pretty good. It's below 50%; it's about 49%. So, actually, GBM doesn't have a problem of costs. It has a problem of return on risk-weighted assets.

Iain Mackay

On a peer group comparison

Stuart Gulliver

On a peer group basis, they're actually quite good on costs. It's return on risk-weighted assets, and the need to get that net $130 billion, gross $140 billion out, which Samir and the team have made a very good start on.

Iain Mackay

It really is the capital intensity

Sandy Chen

Thanks.

Rohith Chandra-Rajan, Barclays

Morning. I just had a couple of quick ones, please. The first one's on loan growth, where loan growth slowed, I guess, quite significantly in the quarter. So if we're looking at the quarter, it's sort of 2.5% annualised growth versus 6% year on year. Obviously, note your comments earlier about reallocating $150 billion of the RWAs organically, fairly easily, over the coming years. I just wondered if you could comment on your near-term expectations for loan growth; so, what was driving the slowdown in Q2, and what your expectations are, maybe, for the rest of this year and into next? And then the second one was just to clarify what the current guidance is on BSM. Do you expect the Q2 number to sort of be fairly steady for the rest of the year? Thanks.

Iain Mackay

Sorry, come back with that second question again, Rohith?

Stuart Gulliver

Balance sheet management.

Rohith Chandra-Rajan

Sorry, balance sheet management guidance for the year. Do you expect it stable on Q2 in the second half of the year?

Iain Mackay

On balance sheet management, broadly speaking, we expect the total year to sit somewhere between $2.7 billion to $2.9 billion, so broadly consistent. I mean, there's a little bit of variability around volatility and available-for-sale security gain or loss, but broadly speaking, $2.7 billion to $2.9 billion for the year total. Going back to loan growth, we certainly had some dynamics between the first and second quarter, where we had some short-term lending in Asia in the first quarter which was paid down in the second quarter. That was a significant driver, but broadly speaking, over the two quarters, we had about $22 billion worth of growth, but the dynamic between the first and second quarter is that we had, within the first quarter, a step-up in short-term lending which was actually paid down in the quarter. So that distorts a little bit the dynamics, quarter over quarter.

In terms of outlook, I think you see some of what we've got going on in North America, what we've got going on in Asia, what we've got going on in Europe; through Commercial Banking, through Global Banking and Markets. I think the trends are reasonably encouraging. When you look at the retail bank, Wealth Management, the principal markets, again, are the UK and Hong Kong. And, again, in Hong Kong, the position's been reasonably encouraging. I think, in the UK, we've certainly got an increasingly competitive environment. Some of our peers look as if they're in a position to be more robust with that competition in the marketplace, but certainly the business' focus is to be responsive to that competitive environment, particularly in mortgage lending in the UK.

Rohith Chandra-Rajan

Okay, thanks. So, thinking about the second half, we should look at the first two quarters of the year together as a – sort of, be a reasonable guide to what you're anticipating to the second half.

Stuart Gulliver

Yeah, you should. Because, as Iain says, there was distortion running first, second quarter. There was a lot of short-term stuff in the first quarter that got repaid in the second quarter; kind of large, lumpy GBM stuff in Asia.

Rohith Chandra-Rajan

Okay, thanks very much.

Arturo de Frias, Santander

Hi, good morning. Just one question from me, please; just one question. Would you share with us your current thoughts on ring-fencing, how the preparations are evolving, and if you have a more accurate or an initial impression of what would be the run-rate of extra costs that ring-fencing would imply for the business, that would be very useful. Thank you very much.

Iain Mackay

Ring-fencing – I would say the preparations are going well. We've got a business design that has been certainly concluded upon internally, which I think is no doubt subject to review with our regulators, but I think we've kept them very, very closely engaged with what we do. I think we've got a very high level of engagement with the PRA and the FCA around the ring-fencing efforts overall. In terms of operational subsidiarisation – so taking some of the core operating capabilities and separating that from the ring-fenced and non-ring-fenced bank, which is part of the wider recovery and resolution planning – very, very significant progress made in terms of setting up those ServeCos, both for the holding group as well as for the UK. And, actually, beginning to transition operating capabilities into that legal entity has already occurred, and will continue to occur, over the remainder of this year and through 2016. So, good progress in that regard.

I think we're very clear as to the initial requirements of the primary legislation, and progressively, the PRA is providing greater clarity around secondary legislation on implementation requirements, and that will continue. On costs, you know, there's a great deal of focus inside the firm on trying to find the most efficient way to deploy the ring-fenced bank. I think it's fair to say that the highest costs that we are likely to incur is around systems separation, and ensuring that there is integrity, both for the ring-fenced bank and the non-ring-fenced bank, in that regard. But broadly speaking, the guidance that's been provided

some time ago by the Chairman and repeated several times since, I think, is fairly reasonable guidance to follow through. So what that boils down to, Arturo, is significant cost to implement the ring-fenced bank, but we do not believe there are significant incremental costs to running the ring-fenced bank once established

Arturo de Frias

Okay. When do you think you are going to share with the market the amount of that initial one-off cost?

Iain Mackay

We have already. Between $1 billion and $2 billion.

Arturo de Frias

Thanks

Stuart Gulliver

Thanks very much. Time for two more questions.

Raul Sinha, JP Morgan

Can I just have a follow-up, please, on costs, and then a broader question on regulatory changes on capital? The first one is, I think you had a discussion with Chris about the cost number, $31 billion mark to market excluding the levy. As far as I can see, that is consistent with the $32 billion that we discussed at the investor day. Is that broadly correct, and now we should start thinking about –

Iain Mackay

That sounds right.

Raul Sinha

Yeah, so effectively it's not a change. What we should start to do is think about it ex-levy, because the levy, obviously, is going to change a lot. So your cost base is probably $31 billion in terms of the target. I guess that – is that correct?

Iain Mackay

Correct, the $32 billion included levy.

Raul Sinha

That's what I thought. That was my initial impression. The second question I had was on regulatory creep; effectively, this Basel paper on operational risk. I get the $290 billion redeployment or return argument, but what I struggle with is how much you lose in terms of regulatory changes, and I was wondering if you had any update on how much you might expect to have an increase in terms of the RWAs from the Basel paper on operational risk.

Iain Mackay

There's a wide range of possible outcomes on this, Raul. And we talked about this a little bit on 9 June – actually, quite a lot on 9 June. Whether it's a fundamental review of the trading book, whether it's op risk, whether it's credit risk under a revised standardised approach, each of those are still very much under review at the Basel committee. Each of those are still very much moving feasts. There are different views by different jurisdictions around the world as to how to approach a new standardised – on credit risk, for example. So there is a wide range of variability.

I think the only thing on which, perhaps, we've got reasonable assurance is the likelihood of any impact is probably, at the very earliest, 2017, but more probably 2018 and beyond. So in terms of to what extent it impacts the business – I wish I could, because if we could, we'd plan for it, but at the moment, it's very

difficult to give you any quantification as to the likely outcome of that. And, literally, the outcome could be from zero to very significant.

Raul Sinha

Isn't it fair to then assume that any discussion about regulatory capital is essentially – in terms of excess or returns, probably a 2018-type discussion?

Iain Mackay

Again, I don't know how to answer that question. Hopefully, we'll get increasing clarity as those consultation processes develop. So, for example, there's another QIS coming out on credit risk, which we will clearly engage in. We believe that that QIS has come out because the previous two or three QIS's didn't provide either the granularity of information that was required, or a consistent view on how a remodelled approach to standardised risk in the credit portfolios would be accomplished. So, as that develops, then we will be able to update how we view it and how that will inform redeployment of capital into certain products and marketplaces, and our assessment of where possible surpluses of capital may exist and therefore how that capital would be returned to shareholders.

Stuart Gulliver

I don't think we should assume that this is consecutive and you need to wait until 2018. I wouldn't start putting that into your model. I think that we'll get much greater clarity before then, and clearly, we're going to crack through getting the 290 out.

Iain Mackay

So the 290's important. Clearly, in the first half of this year, we've generated 50 basis points of capital.

Stuart Gulliver

Just organically.

Iain Mackay

A very significant proportion of which came from the operations of the business, and that's the important thing. Over $5.5 billion worth of capital from the operations is in that 50 basis points of capital improvement at a common equity tier 1 perspective. So, as ever, there's multiple moving parts in this equation, but our focus is on capital efficiency through the RWA redeployment that Stuart talked about; the efficiency of the operations, which is about, clearly, revenue generation, but cost efficiency with a very, very significant focus on that, maintained and strengthened – and then, yes, as has been the case for the last few years, a regulatory mix in the middle of that, which, as clarity becomes hopefully more abundant, we'll share with the marketplace. And all those factors taken together will inform capital redeployment and capital return to shareholders.

Stuart Gulliver

So don't assume that regulatory uncertainty would defeat those two.

Raul Sinha

Okay. Thanks very much.

Chintan Joshi

If I look at your growth in the quarter – $22 billion – and if I look at that as a trend, you're talking about $130 billion compared to kind of $150 billion that you feel comfortably will come through, and compared to the kind of $180 to $230 billion target. Perhaps you've already mentioned your thoughts on growth, but perhaps I can dig into where that $22 billion of growth came from in this half as a follow-up.

Iain Mackay

Broadly, that $22 billion came across Commercial Banking and Global Banking and Markets. In terms of market presence, it came across Asia, North America and Europe, and within North America, it was the US and Canada.

Chintan Joshi

Okay, thank you. And how much from Asia, specifically?

Stuart Gulliver

$12 billion. It's about $12 billion of the $22 billion.

Chintan Joshi

Thank you.

Stuart Gulliver

Okay, thanks very much, everyone.