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Interim Results 2016

Conference call with investors and analysts

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

HSBC

Douglas Flint, Group Chairman

Welcome to the 2016 HSBC interim results call. I'm Douglas Flint, Group Chairman, and I'm speaking from London. Stuart Gulliver, the Group Chief Executive, and Iain Mackay, Group Finance Director, are in Hong Kong.

Before we start, I would like to say a word on behalf of the Board. The first half of 2016 was characterised by spikes of uncertainty, which greatly impacted business and market confidence. This was reflected in lower volumes of customer activity, and higher levels of market volatility. We came through this period securely, as our diversified business model and geographic profile again demonstrated resilience in difficult market conditions. It is evident that we're entering a period of heightened uncertainty, where economics risks being overshadowed by political and geopolitical events. But we're entering this environment strongly capitalised and highly liquid.

Amidst all this turbulence, our strategic direction remains clear. Nothing that has happened casts doubt on the priorities we laid out just over a year ago, although in some areas events have impacted the timescales in which we can meet them. We remain well positioned for all of the major global long-term trends, and the achievements of the last 12 months have only served to strengthen that position.

Earnings per share were 32 cents. Our first two dividends in respect of the year of 20 cents in aggregate were in line both with our plans and the prior year. In light of the uncertain environment, but recognising the resilience of the Group's operating performance, the Board is planning on sustaining the annual dividend at its current level for the foreseeable future. Let me now hand over to Stuart to talk about the context around our results, before Iain takes a more detailed look at performance. Stuart will then give an update on the implementation of our nine strategic actions.

Stuart Gulliver, Group Chief Executive

Thanks, Douglas. So turning to slide 2, we performed reasonably well in the first half in the face of considerable uncertainty. Profits were down against a strong first half of 2015, but our highly diversified universal banking business model helped to drive growth in a number of areas. We also captured market share in many of the product categories that are central to our strategy.

Revenue was done on an adjusted basis. Global Banking and Markets weathered a large reduction in client activity in January and February, particularly in Equities and Foreign Exchange, but staged a partial recovery in the balance of the half. Retail Banking and Wealth Management was also affected by reduced client activity. This led to lower revenue in our Wealth businesses, albeit against last year's strong second quarter, which was boosted by the Shanghai-Hong Kong Stock Connect. There was also revenue growth through higher lending balances in Mexico, and increased customer deposits in all but one region. Commercial Banking revenue grew on the back of targeted loan growth in the UK and in Mexico, and higher client balances in Global Liquidity and Cash Management, which is the new name for Payments and Cash Management.

We also continue to make material progress in cutting costs. Adjusted operating expenses were down 4% thanks to our tight cost control, and the accelerating impact of our cost savings plans. We're on track to hit the top end of our $4.5 billion to $5 billion cost savings target. Our loan impairment charges increased, mainly in the oil and gas, and metals and minings sectors, and in Brazil due to weaknesses in the Brazilian economy. We, however, remain confident of our credit quality.

In July, we were named as the "World's Best Investment Bank" and the "World's Best Bank for Corporates" at the Euromoney Excellence Awards. Important point here is that these awards specifically recognise the benefits of our diversified, differentiated business model, and the increased collaboration between our businesses. The citation describes HSBC as "one of the most joined up firms in the industry" and a "growing force in areas such high-yield debt, M&A and equity capital markets." Both awards are a direct consequence of the improvements we've made over the last few years.

We completed the sale of our business in Brazil to Banco Bradesco in July. This transaction will reduce

Group risk-weighted assets by around $40 billion, and would increase the Group's common equity tier 1 ratio from 12.1% at 30 June to 12.8%. In the first half of the year we also removed another $48 billion of risk-weighted assets from the business, $33 billion of which came in the second quarter. This takes us more than 60% of the way towards our target and, actually, including Brazil, more than 75% of the way towards our target, and keeps us on track to deliver the reductions we promised by the end of 2017.

Our strong capital position and stable earnings mean that we are able to retire some of the equity that we no longer require to support the business in Brazil. Having received the appropriate regulatory clearances, we will therefore execute a $2.5 billion share buyback in the second half of this year.

Our US business achieved a non-objection to the capital plan it submitted as part of this year's Federal Reserve CCAR, and this included a proposed dividend payment to HSBC Holdings in 2017, which would be the first payment to the Group from our US business since 2007. Iain will now talk you through the numbers.

Iain Mackay, Group Finance Director

Looking quickly at some key metrics for the first half on slide 3, reported return on average ordinary shareholders' equity was 7.4%. The reported return on average tangible equity was 9.3%. And on an adjusted basis we had a negative jaws of 0.5%. The movement in jaws was due to a 4.5% climb in adjusted revenue, which exceeded a 4% fall in adjusted costs.

Slide 4 takes us from reported to adjusted numbers. Reported profit before tax of $9.7 billion for the first half included a $1.2 billion gain for fair value in our own debt relating to credit spread, a $580 million gain on the disposal of our membership interest in Visa Europe, $1 billion of costs to achieve, an $800 million goodwill impairment in Global Private Banking in Europe and $723 million of legal settlements and provisions. Allowing for these items leaves an adjusted profit before tax of $10.8 billion for the first half. You'll find more detail on these adjustments in the appendix; we'll focus on the adjusted numbers for the remainder of the presentation.

The next few slides will provide a rundown of our performance in the second quarter. Adjusted profit before tax was $607 million lower than the second quarter of 2015 due to lower revenue and higher loan impairment charges. Operating expenses were $584 million lower than the same period last year. We have split out Brazil from the rest of the Group to show the impact of the sale of the business on the second quarter numbers. The biggest impact is in loan impairment charges, $414 million of which came from Brazil.

Slide 6 analyses revenue. In Principal Retail Banking and Wealth Management, revenue was $422 million, or 7% lower than the second quarter of 2015. This was due to drop in Wealth Management revenue, which contrasts with a strong performance in the second quarter of last year. To put that into context, last year's second quarter benefitted from positive market sentiment, the removal of dealing caps by Chinese regulators and large flows of funds associated with the Shanghai-Hong Kong Stock Connect. By contrast, total stock market turnover in Hong Kong was down 62% in this year's second quarter, with an associated impact on revenue.

Non-Wealth Management related revenue increased by 3%, largely from greater deposits in Hong Kong and the UK, and from higher personal lending in Mexico. The standout performance in the quarter came from Commercial Banking, which continued to grow in spite of the slowdown in global trade. This was driven by higher lending and deposit balances in the UK on the back of market share gains.

Client-facing Global Banking and Markets and Balance Sheet Management recovered in the second quarter after a difficult start to the year. Revenue was 3% up on the first quarter. Against last year's second quarter, revenue was down by $234 million, or 5%. This was largely caused by a fall in Equities revenue due to market volatility, which reduced client activity. There were increases in revenue in Global Liquidity and Cash Management and Rates, and a $114 million increase in Balance Sheet Management.

Loan impairment charges were $394 million higher than the second quarter of 2015, but stable compared to the first quarter of this year. $188 million of the increase from last year's second quarter came from Brazil, due to deterioration of the economy there.

Charges in wholesale were up by $263 million, mainly in Global Banking and Markets in the United States. The second quarter included a single significant charge on a metals and mining related exposure, as well as charges in the oil and gas sector.

Following the outcome of the UK referendum there has been a period of volatility and uncertainty, which is likely to continue for some time. We're actively monitoring our portfolio to quickly identify any areas of stress. However, it's still too early to tell which parts may be impacted and to what extent.

In the meantime, it's worth noting that the LTV ratio on new mortgage lending in the UK was 59%, compared with the average of 41% for the total mortgage portfolio. There's a detailed overview of our oil and gas, metals and mining, UK lending and mainland China exposures in the appendix.

Adjusted operating expenses, excluding Brazil, were $583 million, or 7% lower than the second quarter of 2015, and broadly level with the first quarter of 2016. We achieved this reduction while also absorbing inflation, and continued to invest in regulatory programmes and compliance. We delivered $497 million of cost savings in the second quarter, which was $132 million more than we delivered in the first quarter.

We were therefore able to achieve positive jaws in the second quarter, despite the difficult revenue environment. On a run-rate basis, we have now achieved more than $2 billion of cost savings, which represents nearly 40% of the overall savings required to achieve our 2017 exit rate. We remain confident of achieving this target.

Slide 9 gives you a sense of the difference that some of these cost savings are making. In the last 12 months we've reduced the number of manual payments by 64%, increased the number of customers using our digital channels by 6%, shortened average client on-boarding time by 30% and reduced the number of branches in our six largest markets by 7%.

Slide 10 breaks down adjusted profit for the first half of the year by global business and geography. These profits were achieved in challenging market conditions and relative to a strong first half of 2015. The main business drivers were lower revenue and higher loan impairment charges, which exceeded the 4% reduction in costs.

Turning to capital on slide 11, the Group's common equity tier 1 ratio was 12.1% on 30 June, compared with 11.9% at the end of 2015. Roughly half of this increase came from profit generation. The rest came from a reduction in risk-weighted assets, partially offset by movements in foreign currency translation differences.

Total risk-weighted assets decreased by $21 billion in the first half of the year. This was caused by $48 billion of reductions due to RWA initiatives and $9 billion of foreign exchange movements, partially offset by a $15 billion increase from book quality and a $19 billion increase in book size.

As shown on slide 12, we recognised $33 billion of risk-weighted asset reductions in the second quarter, bringing total reductions for 2016 so far to $48 billion. Risk-weighted asset reductions in the first half included $23 billion from Global Banking and Markets, $12 billion from CML run-off portfolios and $11 billion from Commercial Banking.

These reductions include Global Banking and Markets legacy reductions, better linking of collateral and guarantees to facilities, client facility reductions and moving exposures from a standardised to an IRB approach. The total reduction since the start of 2015 now stands at $172 billion, around 55% of which came from Global Banking and Markets. This takes us more than 60% of the way towards our target. These numbers exclude the reduction in risk-weighted assets from the sale of Brazil, as it closed after the end of the half. That will remove an additional $40 billion of risk-weighted assets. We remain on track to hit our risk-weighted assets reduction target. I'll now hand back to Stuart.

Stuart Gulliver

It's been just over a year since we presented our actions to improve returns and get the most from our international network. The rest of this presentation will bring you up to date with what we've done and how far we've come.

We showed you a version of slide 14 at the start of our Investor Update in June 2015. These are the three core strengths that anchor the investment case for owning HSBC. We continue to build on these intrinsic strengths through our strategic actions, and they continue to underpin the strategy of the firm. We've maintained a highly diversified group, with stable earnings built on prudent, low risk lending, and we've continued to strengthen our capital ratio in the last 12 months.

Slide 15 shows the progress we've made in implementing our actions in the first half. On the right hand side we've added a status update column, which tells you which actions are due to be completed on time. As you've already heard, our risk-weighted asset reduction programme and cost-saving programme are both well on track. We've made further progress on both in the first half of the year, and we're confident of hitting our targets.

Mexico is also on track. We've made good progress rebuilding the business, increasing revenue, controlling costs and recapturing market share. Our shares of the Mexican Payroll and Personal Loans market are up significantly. And we've increased volumes and market share in both Cards and Mortgages. We also have double-digit revenue increases from Retail Banking and Wealth Management and Commercial Banking in Mexico.

Our pivot to Asia is moving ahead, despite the difficulty in re-allocating the risk-weighted assets that we've saved. The proportion of Group revenue that Asia provides has actually continued to rise, and we've made market share gains as a consequence of the investment in our Asia businesses. Having said that, we've not re-allocated assets as fast as we wanted due to the state of the global economy. We continue to develop our Asia businesses and to build on our existing operations, but we're not going to accelerate this programme until it is in the interests of shareholders to do so.

We also remain on track to set up the UK ring-fenced bank by 2018, and we continue to implement Global Standards throughout HSBC. Some of our other actions are taking longer to complete. The US business isn't performing as well as we wanted, due mainly to changes in the external environment. Revenue is up in the Principal business, but not by as much as we hoped, and the credit environment continues to be difficult, especially in oil and gas. Given these circumstances, it's unlikely that the US business will hit its targeted return on risk-weighted assets by the end of 2017.

That said, we have made good progress in reducing risk-weighted assets in the US. We received a "no objection" from the Federal Reserve to the capital plan submitted through the CCAR process. This included a proposal to pay a dividend from the US business back to the Group in 2017. This is a consequence of the progress we've made in winding down the legacy CML portfolio over the last 12 months, and if it goes ahead, it will be the first dividend from the US business since 2007.

The slowdown in global trade has hampered our ability to deliver growth above GDP from our international network. However, revenue from Transaction Banking is down just 1% on the same period as last year, despite a drop in global trade volumes of more than 8%. This reflects the market share gains we've made since last June, and it's a good indicator of the potential of the business when trade volumes start to recover. We are behind on our revenue target for RMB internationalisation, again due to external conditions. We still expect to hit our revenue target, but later than originally planned.

Slide 16 shows we've built up a healthy capital position over the last five years. We've done that through a combination of strong profit generation, a reduction in low return activities and selling businesses that don't deliver value for the Group. We now have a common equity tier 1 ratio of 12.1%, which would rise to 12.8% excluding Brazil. This is well within our 12% to 13% target range.

In the current environment, there are limited options to reinvest the proceeds from the Brazil transaction in higher-return opportunities, and we are confident of our ability to sustain the dividend. At the same time, the sale of the business in Brazil means we no longer need all the equity that supported it. We have therefore applied for and received permission for a $2.5 billion share buyback following the Brazil transaction, which we will execute in the remainder of this year. We intend to carry out further share buybacks as and when appropriate, subject to the execution of targeted capital actions and, of course, regulatory approval.

In summary, and as slide 17 shows, we've made a lot of progress since last June. The revenue environment continues to be difficult, but we're delivering on costs and achieved positive jaws in the second quarter. We've maintained our leadership position in Transaction Banking, and we've captured market share in some of our key Asian markets and businesses. We sold the business in Brazil, and intend to buy back shares to retire some of the equity that supported that business. The Fed has no current objection to the US business paying capital back to the Group in 2017, which includes the proceeds of the sales of the US credit card business and the upstate New York branches in 2012. We also continue to generate capital.

The economic and geopolitical environment remains uncertain. Negative rates and the likely deferral of interest rate rises put increasing stress on banks. Since 2007, we've seen our net interest margins contract from 2.9% to 1.8%, which we largely compensated for with around 33% growth in interest earning assets.

We continue to see higher margin business roll off with heightened competition for new lending. In light of this, we will not now hit our return on equity target of more than 10% by the end of 2017. However, the above 10% target remains both intact and appropriate.

We have confidence in our ability to sustain the annual dividend at current levels through the long-term earnings capacity of the business and our ability to generate capital. There is much still to do but we are making progress in all of the areas within our control. In the meantime, our balanced and diversified business model, strong liquidity and strict cost management make us highly resilient in the current operating environment.

We'll now take questions.

Alastair Ryan, Bank of America

First, loan growth in the first half, as you alluded to, Stuart, was disappointing. It was down a bit. Net of continued run-off in GB&M, do you think that loans will actually grow over the next six to nine months, or the environment doesn't allow for that? That's the first question. And secondly, on the capital returns, obviously the US is a very big number down the road, so you've characterised the share buyback today as a discrete thing relative to Brazil. Clearly in the US – the capital trapped there has been a very big drag on Group cash flows for the last several years. Can I draw you on the quantity of dividends you might get out of there? You mentioned the disposals, but I'd imagine you wouldn't have asked for the ability to pay all of that up front, that you'd have started small, be scaling that later, but it could be quite material free cash flow for the Group over time. Thank you.

Stuart Gulliver

On the loan growth, one of the ways to look at it is the A/D ratio is one of the lowest it's been. So we've got an A/D ratio sitting at 69% or thereabouts. And we obviously have got within the advances several moving parts. We're also continuing to run down, as you say, the low returning stuff in GBM. We're considering to dispose of pieces in the CML portfolio. And opportunities to get accretive loans on the book have been hard to come by.

My preference, in terms of correcting the A/D ratio back to above 70% is to increase the advances rather than turn deposits away. But it's very hard for me to categorically sit here and say that we will see that outcome. What I would say to you is that CMB, RBWM and GBM are all basically focused on trying to win new business. So it is possible that in the second half we'll see net loan growth, because that is what we're trying to do. Actually, Commercial Banking has been successful in doing it, and the positive growth in RBWM actually came from lending, because the wealth management business that was affected by the tough stock markets of the first two months of this year.

So that's what we're trying to do, and we're trying to get the A/D ratio back up to 70% by growing the 'A' as opposed to some complexity around pushing deposits away. We continue to grow deposits. We continue to basically see a flight to quality. And therefore it's for us to push on the advances side. But, as I say, there are two or three, as you know, moving parts in terms of RWA reductions, which means we're exiting a bunch of lending, the CML disposals etc.

On the capital returns, I'll start and I'll let Iain talk a little bit more. One of the ways to think about the US is that the proceeds of the businesses that we sold in 2012/2013 were kept in the United States. So the sub-prime credit card business, the upstate New York branches – the proceeds of those sales were left in the United States. And this will be the first time that we get some of those proceeds released. And just as we said about Brazil, if we don't have the business we don't need the shares that supported the business. You can imagine that some of that logic is behind our thinking about the return of capital from the US – the shares that supported that credit card business, and shares that supported those upstate New York branches, aren't needed any more. You'd be wrong to assume that it's the full amount of those proceeds still sitting in the US that will be coming out. I'll let Iain talk to the amounts we think may be coming back to us in the first quarter.

Iain Mackay

We've talked on these calls in the past about the quantum of capital that's possibly been trapped in the US over the last few years, and Stuart's informed the factors that contribute to that. As we put the capital plan together as part of CCAR this year we had, as you would expect, quite detailed conversations with the Federal Reserve Board. There are two windows for capital planning: the next four quarters and then the five quarters that come after that. We put a substantial dividend in the second five quarter window – in the first half of 2017.

As Stuart says, the dividend won't cover all of the capital that released from the US business disposals, but it's a big number that, certainly, were we to get approval once again from the Federal Reserve in next year's CCAR, then conceivably – and there's a bit of conditionality around this – it could lead to another buyback.

Rohith Chandra-Rajan, Barclays

Just returning to capital return. I guess, from a slightly different angle, you just talked about the shares no longer being needed to support businesses that you no longer own. But thinking about it from a Group capital perspective, post the Brazil fail and the share buyback, CET1 looks like it would be around 12.5%, which is the middle of your –

Stuart Gulliver

12.6%.

Rohith Chandra-Rajan

12.6%, so the middle of the target range. I'm just wondering is that the capital level above which we should think that share buybacks will be considered in the future, so surplus capital above that level, or is that being too specific about the CET1 ratio?

The second one is just in terms of the RoE outlook, 10% not achievable in the current environment. I'm just wondering what you think is achievable in the current operating environment and to what degree there might be additional cost reductions. You've already talked about being at the top end of the $4.5-5 billion range. I'm just wondering to what degree, near or medium term, there might be scope to exceed that.

Stuart Gulliver

There isn't room to increase the cost programme beyond the $5 billion, between now and the end of 2017, which is 18 months. We'll deliver the top end of that $4.5-5 billion, but obviously you would expect, if there is not a pick-up in revenue, that we would need to look at further cost actions and we'd need to look at capital actions in order to get to that 10% ROE. There's a path dependency here; it's either revenue or it's capital or it's costs. We're fully aware of how the math works, but we'll get the $4.5-5 billion out. If we were to accelerate more now, we'd damage our compliance, Global Standards, our customer service and, ultimately therefore, our revenue. The $4.5-5 billion we'll deliver. We'll deliver the top end of that. Then, my expectation is we will continue into 2018 and 2019 with a further programme of cost management. Iain should talk broadly about the range of core equity tier 1.

Iain Mackay

We're already sitting in that 12-13% range. We've always talked about feeling more comfortable in the upper half of that range. The Brazilian transaction, after the effect of this buyback, will put us in the upper half of that range and we have every expectation we'll continue to accrete capital from operations and ongoing capital actions, as we work through the remainder of this year and into next year. Where we will find ourselves post-buyback is a good place to be.

As you are well aware, there are still a number of uncertainties out there, whether on regulatory capital measurement, or with respect to geopolitics and how it might affect the economy. Notwithstanding these, PRA approval for the buyback suggests they have some confidence in the strength of our capital ratios, and our ability to meet capital requirements and generate capital from operations.

Sitting around 12.5%, which is really the level at which we modelled, incidentally, the 10% return on equity from an input equity perspective, is a good place to be. If we find ourselves higher than that as we work through the remainder of this year, we won't be particularly uncomfortable about it.

What may inform future buybacks, yes, will be our capital sufficiency in meeting regulatory capital requirements, but it will also be very closely aligned to specific capital actions that we take that mean that we are carrying capital that is no longer necessary to support the businesses that it underpinned in the first place. There is absolutely an intention to be in a position to do further buybacks, but it will be very much linked to specific capital actions that we will continue to undertake within the businesses.

Raul Sinha, JPMorgan

Am I reading too much into it that, if I look at the $2.5 billion buyback that you've talked about, that's broadly similar to the scrip element of your overall dividend? This is one of the things you wanted to do in the past. Should we think about potentially the dividend as you effectively adjusting it to make it a full cash dividend, rather than have a substantial scrip element that leads to a rise in the share count? The first question is: are you looking to manage the share count impact of the scrip through the buyback? Is that your intention at all?

The second one I have is on interest rate gearing. On page 80, you've given us the disclosure on the various moving parts across different blocks. The exposure to the sterling bloc has come down over the last 18 months, and so I just sort of wanted to get your thoughts on what is driving that negative impact being lower now, at $442 million, compared to what it was before in the last two periods. Maybe you could touch upon what mitigating actions you could take against the UK rate cut. That would be useful, thank you.

Iain Mackay

On the buyback, it is very directly linked to Brazil. It is not – and you shouldn't read too much into this – about specifically trying to manage down the impact of the scrip. Clearly one of the factors that we are focused on is the share count. Obviously the long-term sustainability of our dividend is to a not-insignificant degree informed by managing dilution that comes from the scrip. To be very, very clear, this buyback relates to the Brazilian transaction. If that then, over time, allows us through other capital actions to execute further buybacks that manage down the impact of dilution, then we'll be very happy to do that and it is absolutely a goal for the organisation. Don't link the buyback, directly or indirectly, in any way to the scrip. We'll certainly keep you informed, as time goes forward, as to any actions that we may take with respect to the scrip.

In terms of NII sensitivity, specifically in the sterling bloc, I think there's not really a great deal. What we've very much done within sterling, both from capital management and more broadly the balance sheet, is where there's been an opportunity to hedge exposures within the sterling bloc, we've taken those opportunities progressively over the course of the last 18 to 24 months, and we'll continue to do so. That's probably the main impact that you're seeing of slightly less influence coming through the sterling bloc from a rate sensitivity standpoint.

Stuart Gulliver

I also think that what you're looking at, as the position matures, if you look at what you're examining, is basically January to December this year, you have this $135 million impact if rates went up, which obviously is not what we're expecting, Actually in July 2016 to June 2017, the impact is less. That actually suggests to me there's simply a maturity of the position, nothing more remarkable than that, quite honestly.

Raul Sinha

In terms of mitigating actions, what actions could you take to perhaps re-price some of the business in the UK?

Stuart Gulliver

We think that the impact of a 25-basis-point cut will be about $100 million to the net interest margin for the remainder of this year, so about $200 million annually, which is the impact of inability to price deposits further. It's a competitive landscape and it really depends on, effectively, what margins are across the industry. There aren't any magic buttons on this.

I guess, if your question is code for would we charge people to put deposits with us, we already have. With our business clients, we've written to them indicate where, for non-sterling deposits, if interest rates were to go negative, we would pass on the cost of that to business accounts and to corporates. In foreign currency, we're already doing that with banks and non-bank financial institutions. I guess that protocol would read across to the UK if sterling rates became negative. Again for foreign currency, we have not done it with personal clients and we have not, at the moment, even contemplated that for the UK.

Given that Governor Carney has indicated, on a number of occasions, that he is not in favour of negative interest rates, and obviously it remains to be seen what action he takes tomorrow, we have not reached the stage that I think RBS has of writing out to people on this. As I say, the expectation would be, if you got negative interest rates, yes, we would apply it to companies and we would apply it immediately to banks and non-bank financial institutions. If that's what you were asking within that, yes, we would do that, but I don't think there is going to be a re-pricing from a credit spread point of view.

Michael Helsby, Bank of America

Just on the dividend, so obviously you dropped the progressive dividend guidance. I was just wondering if you could talk about and maybe join it all up, because you're left in an unusual situation, where your ordinary dividend is barely covered at the Group level, yet your core tier 1 is, as you say, going to be at the top end of your range. You've got these discrete buckets of capital, the US being one, maybe China in the future. How should we think about that? I'm just conscious that clearly there's an expectation in the market that you're going to cut your ordinary dividend at some point in the future, so I'm just wondering how we should think about that and how you think about the cash flows going forward.

Then just on the RoE, I appreciate and thank you for the commentary that you don't see it as being achievable next year. Can I draw you on whether you think a 10% return on tangible equity would be achievable next year? Thank you.

Iain Mackay

On dividends, Michael, I would take our guidance literally. Our focus is on sustaining the dividends at the current level. Your point on coverage is taken and well understood. We clearly would be paying out, in 2016 and 2017, at a higher rate than we have historically. That is influenced by a couple of factors. One, we've obviously got the impact of the Brazilian accounting in the second half of the year that will come through. We have the impact of about $1 billion so far, year to date, of our cost to achieve, which includes restructuring and other costs to ensure that we deliver on risk-weighted asset reduction, cost savings and overall improvements in the operating efficiency of the firm. We continue to have, obviously, the impact of a fairly lofty Bank Levy coming through and impacting holding company cash flows, as well as higher tax rates in the United Kingdom. As you can imagine, there are lots of moving parts.

When we look at the profit-generating capability of the business, the ability of our subsidiaries to continue to dividend to the parent substantial cash flow, that supports our dividend, albeit at higher pay-out ratios. Why would we be comfortable with higher pay-out ratios? It really goes to some of Stuart's earlier comments that the ability to take capital and reinvest it profitably in growth opportunities presently is somewhat muted, as I think we all see in the various markets in which we operate around the world.

Consequently, because we're sitting at the higher end of the common equity tier 1 ratio that we've got, which we've targeted and is certainly based on approvals received, it would suggest that our regulators are happy with how we're progressing in that regard. It seems not the best use of the shareholders' resources to keep it on our balance sheet but, actually, to put it back in their pockets in the form of dividends and, when circumstances allow, in the form of buybacks. That is where we're headed right now. I would take the guidance on dividends as literally as we have put it to you.

Stuart Gulliver

Just one small point I'd add as well, Michael: our profit before tax is a lot less volatile than others. If you go back over 10-15 years and look at what we make each year, and then compare it to some other banks that have struggled to keep a dividend, actually to keep any dividend, you'll see not only do we have all the things Iain said and we've got big distributable reserves and so on. Actually, we're a lot less volatile. It's because we're a global universal bank and very diversified by geography and customer group, which of course was seen as a big negative, but actually is the reason why we've got the numbers we have. It also gives us confidence that, if you like, we can distribute more than others would for a couple of years.

Iain Mackay

Michael, going to your return on tangible equity question, certainly when you look at some of the factors that impact return on equity, obviously the lower revenues and higher loan impairment charges in the current period impact the return on equity. When you then look at the costs to achieve, we've got significant costs to achieve coming through in each of 2015, 2016 and 2017. As they start to fall away and as, hopefully, we start to see a slightly lower charge coming through on the Bank Levy, for example – though, interestingly, that's largely offset by the increased surcharge on bank taxes in the United Kingdom – those factors absolutely contribute to moving the RoE in the right direction.

In terms of RoTE versus RoE, we certainly start getting a little bit closer to the numbers that we'd like in 2018 and 2019. We will still fall a little bit short of a return on tangible equity of 10% in 2017. We will not make 10% return on tangible equity in 2017, although we're certainly getting closer to 10% by a different measure, but we don't really want to game you on the measure here.

Chira Barua, Sanford Bernstein

Just a quick one on risk: the early delinquencies, especially one month plus, there's been an increase in June. It would be great if you could just give us some colour on where those delinquencies are coming from. I think it's on page 7 of the presentation, about $9.1 billion in total.

Iain Mackay

This is in the US, principally in the corporate and commercial sector. That really is just demonstrating some 30-day volatility that we see coming through short-term customer behaviour. That is influenced by a pretty small number of individual customers in the corporate sector, in the US.

David Lock, Deutsche Bank

The risk weighting in the Retail Banking division looks like it fell about 2%, quarter on quarter. I appreciate that some of that's going to be driven by the US CML run-offs. It looks like there was quite a big drop in Europe as well, so I just wondered if you could comment on what exactly is driving that and whether you see any risk around the low mortgage risk-weight you have for the UK, which I think was about 5% this quarter.

My second question is just on BSM. I think on the last call you gave an expectation of about $2.5 billion for this year, and clearly you're ahead of that in the first half, so I just wondered if that was still the expectation for this year.

Finally on cost of funds, I'm a little bit surprised to see that cost of funds is actually slightly up, half on half, from about 0.97% to 1.01%. If you could call out what was the driver of that, because obviously in the interest rate environment I'd have thought it would be falling, not rising. Thank you very much.

Stuart Gulliver

Thanks. Some of the cost of funds is TLAC.

Iain Mackay

It's TLAC and AT1. As you'll have noticed, we did a significant amount of issuance.

Stuart Gulliver

About $18.5 billion of TLAC and about $3 billion of non-core capital in the first half.

BSM, $2.4-2.8 billion.

Iain Mackay

Risk-weighted asset density in Retail Banking and Wealth Management, you hit on the point, which is continued significant reduction in the run-off CML portfolio in the US where, in the first half, we completed dispositions of about $4.7-4.8 billion. In July, we completed about another $1 billion of dispositions from the same portfolio, but that's obviously not reflected in those numbers. There's nothing else of particular note within Retail Banking and Wealth Management from an RWA density perspective.

David Lock

Okay, so what was the driver of the European fall? Was it just quality of book?

Iain Mackay

There is nothing significant within that. Certainly from an RWA density perspective, the book came down slightly in size, but that doesn't impact RWA density – nothing notable.

Jason Napier, UBS

I appreciate the commentary in Douglas's statement around the necessity of trying to align public policy and regulatory policy. While we probably all agree with that, there's obviously the implication in there that your own QIS work signifies potentially very material changes there. It's obviously a good sign that the PRA is allowing the buyback and your ratios are building in a very promising fashion, but I just wonder whether, given that there probably is material information inherent in this, you might give us a sense as to the distribution of QIS outcomes that you arrived at and what the bigger issues are. Perhaps more specifically, could you talk about what the discussion paper on UK mortgages and yesterday's release on PPI might mean for capital?

The second is just a point of detail. I wonder whether you wouldn't mind giving us the legacy credit RWA number for GBM, just so we can see what's happening to the RWA deployment in that division, in the second quarter. I think looking at the first quarter, there was $25 billion of RWAs left. I just wonder how that's evolved in the second, thank you.

Iain Mackay

In terms of revisions to Basel III, you'll have seen the same sort of commentaries that we have seen, in terms of the Governors and Heads of Supervision making quite strong statements around not having a significant impact on the overall capital requirements for the sector. We're obviously still quite a few months and a great deal of work away from having any final calibrated outcomes, with respect to either credit risk or operational risk.

As you've probably also seen, the impact that the industry has estimated from a QIS perspective, particularly on credit risk, is very, very significant, whether you viewed it from a UK perspective, a European perspective or a global perspective. We obviously contribute to that and I think it would be fair to say that, across certainly operational risk and credit risk, there is potential for very significant impacts for the industry, and it would be significant for HSBC, were the guidance upon which consultation was sought implemented as stands today, it would be.

However, given our capital strength, given the number of capital levers that we have available to us, we have a resilience and a propensity to deal with this, probably in a shorter timeframe than the wider industry would take. To be clear, were these proposals implemented as drafted today, it would be very significant for the industry. Going beyond that, you've read the various numbers that are out there and there's not much more I can particularly add to that debate, at this point.

From a PPI Plevin perspective, obviously we got another consultation from the FCA yesterday. That will run through until 11 October, I believe. We'll obviously participate in that consultation. I think our response to this consultation and how we reflect any possible impact in our numbers will be the same as it was in the last consultation, and that was that we took a view of the likely impact of PPI closing out in April of 2018. We'll now roll that forward to 2019, once we've understood exactly what it is that we are consulting on. If that reveals that there's any increased requirement for remediation to customers necessary, we'll make provision for that in the second half of the year. It will absolutely be informed with every provision we've made for PPI, which is incoming claims, the rate of uphold against those claims and the payment against those claims. That is monitored operationally within our UK business, on a day-by-day, week-by-week basis.

You've probably noticed that there wasn't a particularly material impact from our update for the earlier consultation. You've seen really nothing come through the last couple of quarters on that one. As and when we've worked through the detail, you'll obviously see it in our financials. It's difficult to say until we've worked through the detail.

In terms of RWA density from a legacy perspective within Global Banking and Markets, the overall reported RWAs of $437 billion decreased by more than $3.5 billion, but from the end of the year. A number of factors come into that, reductions of about $27 billion. About $7 billion came in terms of legacy disposals, from an RWA perspective. If you go back to the number you previously had of about $25-26 billion, about $7 billion has now come off that, in terms of activities in the first half of the year. That's what's going on in legacy credit.

Jason Napier

You have one of the lower RWA densities in UK mortgages. Do you have any comments on that discussion paper in particular?

Iain Mackay

I think that's probably got something to do with the quality of the UK mortgage book. We can get into this, because no doubt you'll want to ask a few questions about Brexit at some point and what that means for credit quality. If you look at buy-to-let exposures in the UK, for example, only 3% of our portfolio is buy-to-let exposure. When you look at geographical distribution, London's about 28% of that and 86% of our London exposure has an LTV of less than 60%. If you look at the South East of England, it represents about 13% of our UK mortgages and 80% of that has an LTV of less than 60%. 2% of HSBC exposures have LTVs of greater than 85%.

I could keep reeling off these statistics, but what we've got is a conservatively underwritten, well distributed book of business within the United Kingdom, where credit quality, certainly through the global financial crisis and today, remains very consistent and very stable. When you think about how our advanced models are built, it's all about PDs, LGDs and EADs. Some of the data I've just provided you with would inform why we've got a relatively low RWA density in our UK retail mortgage.

Chris Manners, Morgan Stanley

My first question is about BoCom. I can see that the headroom of the VIU above the carrying value has decreased to about $800 million. Just maybe you could give us a few thoughts on that and how close we are to essentially de-recognising those earnings and the income statement, and how we should think about that.

The second question was actually just on UK asset quality and also a little bit in terms of your customer sentiment. What do you think about demand for credit in the UK? I know this question was asked in brief, but is there any chance of firming asset margins in the UK? One of your peers was saying that banks should think more about pricing for risk and that could give you a little bit of a bump to the margin, in the low rate environment.

Iain Mackay

On BoCom, the main driver of that reduction is payment of the annual dividend by BoCom.[1] The way the accounting goes, the dividend flows through that discounted cash flow model and the book value impact. The other main driver there is foreign exchange. What does this really mean? It means we're several hundred million dollars closer to impairment than we were when we reported these numbers to you at the first quarter. Our approach, and we've got disclosures obviously on this in the Interim Report in some detail, to evaluating BoCom and the potential for impairment on BoCom has not changed in any significant regard. The accounting treatment and the capital impact of BoCom have not changed either. Other than some FX impact and receipt of a dividend, there's nothing else to report on the BoCom front.

Stuart Gulliver

In terms of credit, we had a slowdown in SME activity, basically kicking off from early June, which is still reasonably slow in terms of applications for new financing. Since the referendum, precisely 1,142 loans worth about $150 million have been drawn down for customers in UK CMB's business banking segment.

MME is again quite slow, so people have postponed getting financing for opex, but I imagine that, come September, we'll see that pick up again. Obviously the process of negotiation is going to take a number of years, so I don't think that that opex will be postponed. The large companies haven't missed a beat, because they're multinational and they're in many countries and, therefore, they have continued to operate at the previous levels.

In mortgages, we've approved about 11,500 mortgage applications post-referendum, for a total of about £2 billion. Actually to be honest with you, the slowdown in UK mortgages was more pronounced around the stamp duty increase – i.e. there was a lot of volume in the first quarter that then fell off post-April –

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[1] For further information, see Note 13 (Interests in associates and joint ventures) on page 123 of the Interim Report 2016

than anything we've seen around the impact of the referendum. There really isn't anything particularly pronounced other than, as I say, a slowdown in the SME business banking sector.

I don't myself believe that there will be any opportunities to change credit spread pricing. I think that, notwithstanding the often-repeated view that the UK market is not competitive, it's actually extremely competitive. I would be surprised if credit spreads did move out, unless we're talking about some unforeseen event that results in credit spreads more generally for the UK moving out, which again we're not building into any of our own planning assumptions, at this moment.

Tom Rayner, Exane BNP Paribas

Can I just ask you about your statement on regulatory policy aligning with public policy at the bottom of page 3? Some of the statements – and Iain, you have sort of referred to these already – are quite strong: increased capital requirements would have a major impact on the availability of credit and go against the public policy focus on boosting growth. And also, as you said, you welcome statements from the G20 and others that there'll be no broad-based increase in capital requirements. So, on the back of those comments, I've got a couple of questions.

Firstly, when you talk about 12.5% as the right sort of equity tier 1 ratio to consider buybacks, etc., are you now assuming there will be no impact on you from Basel IV, IFRS 9 and other things outstanding? And my second question is: to what extent are these comments part of a broader industry-wide lobbying exercise, I guess, trying to sort of encourage Basel maybe to look at the reality of the situation and maybe water down some of the proposals? Is that me dreaming again, or is there some substance to that idea? Thank you.

Douglas Flint

I wouldn't call it part of a lobbying exercise. I mean, a consultation process means two sides talk to each other, and I think that the proposals, which were really all around risk sensitivity and then into operational risk and a number of other areas – the aggregate impact if you took the top end of the ranges came to quite significant increases in capital. Now, it's been said for some time by the regulatory community it was not the intention to have a broad-based capital increase. There was an expectation that outliers – those that had a particularly low risk-weighted asset density – might find themselves more hit than others, but for the broad part of the industry it's been fairly consistent.

What I was trying to do in the statement is say that this consultation is underway. Clearly, it's a significant matter to be addressed / resolved in the second half of the year, and I think we are basing our future projections on the very clear statements that have been made by the Central Bank Governors and the G20 finance ministers, as well as the Financial Stability Board and many elements of the regulatory community saying, 'Look, this is not designed to have a broad-based increase in capital.' So, what I was trying to do is say we're working on that basis, and clearly it's important that that is delivered, because in a period of economic uncertainty, any constraint on the ability of the industry to generate credit would lean against public policy objectives in terms of trying to stimulate better growth. So, it's not part of a lobby effort; it's really just pointing out an important event in the second half of the year and to draw attention to the comfort that's been given by the G20 community.

Stuart Gulliver

In terms of what are we assuming about our capital ratio, I'd turn it slightly round the other way. So, post the sale of Brazil, we were 12.8%; after this buyback, we're 12.6%. And obviously to do the buyback, the PRA had to approve, so our main regulator obviously had to think about some of the things that you've just outlined in coming to the decision to give us that approval.

Tom Rayner

I do understand that, but I guess that your main regulator, the PRA, will have to eventually take whatever the final Basel decisions are. I mean, it would be quite a step, I think, for a national regulator in the UK to actually sort of unilaterally say, 'This is' – well, we can all have our own view on it, but –

Stuart Gulliver

No, no, I'm not saying that the PRA is rejecting Basel IV. What I'm saying is the PRA has looked at our five-year capital plan and has decided that they are comfortable with us, having sold Brazil, retiring half the shares that supported Brazil, knowing all that they know, you know and we know about the likely regulatory change. That's all I'm saying.

Iain Mackay

What we're not saying is that there is no impact from any refinements to the Basel regime at this point, because nobody knows.

Stuart Gulliver

We don't know what they are.

Iain Mackay

And so I think, you know, to Douglas's point, you've got to place some faith and reliance on the various statements coming from Central Bank Governors and Heads of Supervision. But by the same token, as I'm sure many of you have, if you have conversations with some of those same Heads of Supervision, they have a very, very significant piece of work to do over the next six months to try and come to an agreement as to what the Basel framework will look like going forward, and it is a substantial piece of work. So, no, we're not saying there is no impact here, but we are simply taking all the factors that are put in front of us from various sources, as, clearly, are our principal regulators, and that's informing decision-making.

Stephen Andrews, Deutsche Bank

I just wanted to come back to the question of capital trapped in North America, can you give a bit more guidance in terms of exactly how much capital you do have in North America? Because obviously from the operating company accounts, we can see Canada, Finance Corporation and the Bank. When you talk about the proceeds from the Cards sale and the branch sale being held in North America, is that being held at the North American Holdings Company level?

Stuart Gulliver

It is, yes.

Iain Mackay

Our consolidated common equity tier 1 ratios in North America are north of 24%.[2]

Stephen Andrews

Okay. So when we're looking at how much capital there is in North America Holdings, we should take those use of proceeds –

Stuart Gulliver

As Iain says, the capital ratio is in the mid-20s, which is quite high. We hope and expect that the dividend payment that we get back to HSBC Holdings will be a material sum, but we obviously aren't in a position to provide a number for that at this moment in time.

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[2] The above capital ratio provided during the call was subsequently corrected during the Post-Interim Results 2016 Analyst meeting. The total capital ratio for the US businesses within HSBC North America Holdings is 24%, with a CET1 ratio above 16%.

Stephen Andrews

Then just a follow-up question on the US. If we look at the remaining businesses on the NAFTA platform, as you call it, it looks like you've probably still got the best part of $30-35 billion of capital tied up there, and although you've made a little bit of progress in Mexico, I mean that's only sort of $3 billion of that capital, and the rest of the businesses are really struggling to generate any return at all. How far away are you from saying, 'Okay, we need another plan – another way to free up that – generate a better return on that $30 billion'? Because at a Group level at the moment, you know, even ex the stuff held at Holdings, it's still a massive drag on Group returns.

Iain Mackay

So if we take each component of NAFTA – you mentioned Mexico and we've talked on this call about the progress that we're making there. We've got a lot more to do in Mexico, but there's good traction and progress being made by Nuno and the team. Canada is a business that continues to generate – even in a higher loan impairment charge environment coming from the oil and gas sector – an attractive return, and on a normalised basis that's a very attractive business for us.

The challenge – and Stuart referenced this earlier in the call – is continuing to move performance within the US business. Broadly speaking, outside the oil and gas sector, and metals and mining, we've got fairly stable credit quality within the US business. We're making progress from a revenue and cost perspective as well. We obviously have to continue to execute against the various compliance objectives that apply to the US but also the wider Group, and progress is being made, but more to do. And then when you come to the surplus of capital sitting in the North American corridors, it is absolutely sitting within that US business. So we come back to your earlier question, which is about getting the capital that's surplus to regulatory and to business requirements back to the Holding Company, such that it can be distributed either in terms of investing in the business or returned to shareholders.

Stuart Gulliver

The whole CML piece has to come out – obviously, the completion of the sale and dismantling of what was Household in the legacy CML books. Then we need to get that capital out and the capital that basically has sat there from the sale of the Cards business and the upstate New York branches while restructuring the business. Now, Retail Banking and Wealth Management in the States is now breakeven. The Global Banking and Markets business and CMB – in the United States, we did actually have an improvement in revenues and a fall in costs, but the LICs swallowed it up. So there's a lot of restructuring work going on, as Iain says. Once we've got the capital back out and with the restructuring work, we will get to a business that has a more accretive return than the one today, but we won't get there, as I said in my presentation, by the end of 2017. But you can rest assured that we're highly focused on this.

But we will always have a US business. We operate in parts of the world where the dollar is predominant. Two-thirds of HSBC's PBT comes from Asia-Pacific and the Middle East. These are dollar-bloc economies. World trade is in dollars. Payments and Cash Management – 60% is in dollars. 80% of world trade is in dollars. In something like 80% of foreign exchange trades, one side settles in dollars. The biggest economy in the world is the US. The biggest source of investable funds is the US. And actually, we make about four times as much with US companies outside the United States as we do in the United States, but that PBT falls in the legal entities or the countries in which that activity took place. So if we do a transaction with an American company in the United Arab Emirates, the revenue's in the United Arab Emirates, but actually the company's American.

So, the US business is not as unattractive as it looks at first blush. There are several pieces within it which causes it to look a lot worse than it actually is, but we accept the fact that there is a ton of work still to do on it. And you can also rest assured that we are tweaking the plan, as you would expect, as we go along.

Manus Costello, Autonomous

Firstly, just a point of clarification about the trapped capital in the US. Can I just be clear that when you dividend this back up from the sale of the cards business, for example, which I think was about a 60 bp benefit, there isn't any benefit to the Group's consolidated ratios from that movement of capital, so is what you're trying to say, if you are organically generating capital by the end of next year, for example, which means that you are above this 12.5% level, you'll now be technically able to return capital? Because I can't see why the dividending up of capital from the US business would directly impact the consolidated Group and your ability to pay.

And my second question, just briefly, is on BoCom. Has there been any further discussion about changing the capital treatment of BoCom? I think in the past you've thought, maybe, about treating it as a material holding. Has there been any re-opening of that debate?

Iain Mackay

You're absolutely right on the US dividend: it would have no impact on the Group's capital ratios, but what it does do is put the cash resources that back up those capital ratios at the holding company, which means it is then within our power to do either reattribution to other investment opportunities or return it to shareholders. But it has no impact on the Group's common equity or other capital ratios by simply moving it from the US to the parent company.

Manus Costello

So what you're really saying is if you are able to organically generate capital between now and 2017 – whenever you're allowed this – you would physically be able to pay it, whereas historically that might not have been the case.

Stuart Gulliver

The dividend is paid out of the holding company. The holding company is a listed company, so the cash has got to be in the holding company, either to fund a dividend or to fund a buyback.

Iain Mackay

It all comes from cash from the subsidiaries in the form of dividends.

Stuart Gulliver

So think about it in cash terms as opposed to purely in capital terms.

Iain Mackay

So capital generation, whether by the Hong Kong bank or North America or Mexico or any of them, it all comes back in the form of dividends to the parent company, so it is absolutely vital that we have capital surpluses sitting at the parent company, to enable the most efficient capital allocation.

On BoCom, the conversation and discussion with our principal regulator continues. It's a good conversation, but it is ongoing.

Fahed Kunwar, Redburn

On slide 8, if I look at your discrete quarter cost growth versus the quarter cost growth taking out regulatory programmes and compliance, there's been around 2-3% drag from regulatory compliance over the last four or five quarters, whereas this quarter, the drag is substantially less. Obviously you've done very well getting positive jaws as well. Can we read that across as the drag from compliance going forward now won't be as high as it was for the last kind of year/year and a half, or is this a kind of one-off thing where compliance spend has reduced in this quarter but could go up again in the next few quarters?

And my second question was just a point of clarification on the margin. Quarter on quarter and year on year for the quarter, what has the net interest margin actually done?

Iain Mackay

So going to the investment in regulatory programmes and compliance, I think we've set out in 2015, in June, quite clearly what we needed to do in terms of investment in this space. That investment is going ahead. Clearly, there's been a huge amount done over the last three/three and a half/four years. There's quite a lot that still needs to be done. So the rate of growth in that investment is slowing, but there is still a broad range of investments to be completed between now and the end of 2017, which is the targeted date for us exiting our Deferred Prosecution Agreement with the United States and the FCA. So the work is going ahead, but the level of investment required remains absolutely consistent with previous guidance.

Fahed Kunwar

Sorry, just to be clear, the drag of 2-3% from previously – can we expect it to go down going forward? Will there still be a drag, but it'll reduce going forward?

Iain Mackay

There will still be an increased cost coming from regulatory compliance programmes, but the level of influence that has overall will decrease.

On your second question, overall, from the Group perspective, interestingly, a little bit of pressure coming through the UK mortgage book, where there's a very competitive environment in terms of pricing in that regard, so we see a little bit of pressure coming through the UK in that regard. Stuart mentioned earlier that there were higher costs of funding coming through from issuance of total loss absorbing capacity qualifying instruments and alternative tier 1 and tier 2, where spreads are certainly wider in the first half of the year than has historically been the case, and that's really it. In terms of Asia-Pacific – very, very stable. North America – very stable; a slightly muted impact with the continued run-off of the CML portfolio. And Latin America actually has strengthened a little bit, with policy rate increases in both Mexico and Argentina. So, a little bit of pressure coming through TLAC in the UK, both in the Holding Company in terms of debt and capital instrument issuance and the mortgage book, but broadly speaking, beyond that influence, which is quite muted, it remains reasonably stable.

Martin Leitgeb, Goldman Sachs

My first question would be on Brexit and the impact of Brexit on in particular your UK business so far. You hint that there was a flight to quality in terms of deposits, and I was just wondering if you could comment on the inflows of deposits you have seen, particularly in the UK, since the outcome of the referendum, so in the past six weeks – whether you saw any change in customer behaviour there.

And the second question in relation to Brexit is: how do you think about UK mortgage growth going forward? You called UK mortgages out, I think in the last call, as one of the key growth areas for HSBC going forward, and I think you also made some considerable investment in that operation. Do you still target to grow in absolute terms that business?

And then lastly just on your very strong loan to deposit ratio, which has been trending down, obviously at least since we tracked that in our models – since 2004 at least, if not much longer. At what point does the loan to deposit ratio become an issue? We have seen some of the US peers proactively addressing some part of their deposit book. I guess it's probably driven by leverage constraint. Is it fair to assume that for HSBC, the loan to deposit ratio wouldn't be an issue, simply because you're constrained by a core tier 1 basis, or does that differ across jurisdictions?

And then lastly in terms of investment of excess deposits and deployment of those excess deposits, could you shed a bit of light on what strategy you have, given obviously the very low interest rate environment at present?

Iain Mackay

The A/D ratio is 69%. Is that an issue? So in terms of overall net interest income, profitability of the Group, I mean you've seen us sitting around an A/D ratio of between 70% to 73%. 69% just means that we've got a slightly more difficult task to do in terms of profitably investing that surplus. The guidance that Stuart gave you with respect to Balance Sheet Management, which is the core group within the Bank which manages our corporate surplus around the world – I think the guidance on revenues and profits remains entirely appropriate. So it's not really a constraint.

I think what we are doing, which is along with many other banks around the world, is we're looking at non-operational deposits – so, deposits that exceed the operational requirements of our customers – and have set operational deposit levels for certainly all of our corporate customers, and where they exceed those operational levels, we're a little bit stricter with them in terms of our willingness to take any further amount of deposits from them or, in certain currencies, as Stuart pointed out, charging for those deposits being held at HSBC. So there's a very strong focus on managing operational deposits surplus to operational deposit requirements within the client base across the Group. That's functioned obviously on the A/D ratio, as well as – that has a very direct impact on the bank levy in terms of the impact that has on us at the end of year.

In terms of deposit inflow in the UK, what we've tended to experience historically is in times of stress we tend to see a bit of deposit inflow. That's been the case both in Asia and in the UK over the course of the first six months of the year. Whether it's particularly related to Brexit it would be very difficult for me to say. In terms of customer activity, Stuart?

Stuart Gulliver

So, mortgages remains a priority in the UK, and actually we've got good growth. So in direct approvals, we have market share of about 24%, which is up 2% year-on-year. First time buyer approvals increased by 45% second quarter 2016 versus second quarter 2015. We've got – remember we did most of our business direct, but we've now started to add some intermediaries on, and so at the moment – we added an additional three in the second quarter, so that means we're now working with five intermediary partners, and we're going to add another 10 by the end of the year. The total book size year-on-year has increased by about 3% in mortgages.

So mortgages remains a focus. The LTVs and the credit standards will remain as high, and you heard Iain go through some of the LTV measures and the mixture of where our exposure was around the country and our exposure to first time buyers, buy to let, etc. But I don't think Brexit changes that. I don't think that Brexit will change the nature of the UK home ownership market at all, so I still think that that is a legitimate market share gain that we can take, frankly, either in terms of absolute growth of the market or taking business off other banks. So I remain confident that the UK bank can continue to grow and indeed has a priority and a focus on growing its lending book there.

We saw, as I said in answer to some earlier questions, some fall-off in loan demand, particularly in the mass business and SME sector, basically starting from early June, that hasn't really recovered. This is more in terms of net new business, so in terms of application for fresh financing. We haven't had people repay us, so it's not that the book is shrinking, but I would expect that to kind of pick up in September, because I don't think that people will postpone opex for very long, and most of this type of financing is short term opex. So I don't see that as a negative either, and the GBM business hasn't really missed a beat.

On managing the A/D ratio, as Iain says, from an operating deposit point of view, with banks and non-bank financial institutions, we already have a protocol around other currencies, like the euro and Swiss franc, where interest rates are negative, which we'd have to look to port across. But I would rather solve the A/D ratio challenge by lifting the 'A' back up than rejecting the deposits. I think it would be very, very wrong for HSBC to change a model that we've had since 1865, which is to be a deposit-funded bank. Now, clearly, the A/D ratio at 69% and interest rates at the zero bound is less attractive than when interest rates were 4% or 5%, but as I say, the challenge for us is to get business on that we can write close to our cost of equity, rather than to turn away deposits.

Balance Sheet Management will continue to manage the balance sheet as it always has done, which is to manage interest rate risk. So, within Balance Sheet Management, we do not really take credit risk. It tends to own government bonds and sovereign supranational type of issuers. I don't want to create a credit portfolio within BSM, and one of the reasons for that is I'd rather take credit risk out of Global Banking or out of Commercial Banking, because then you get the relationship benefit. If you simply buy someone's bonds in the secondary market, there is no relationship benefit to that whatsoever. I don't want us to turn into investors in the same corporate credit to whom we're bankers. I want to be a banker to them, lend to them directly and then harvest the ancillary revenue, and you don't get that if you're simply buying their fixed income instruments. We should be underwriting in the primary market their fixed income, not buying it blind in the secondary market.

Martin Leitgeb

Is there anything you do differently there in terms of the term structure of that Balance Sheet Management book at this stage, or is that something that is relatively steady?

Stuart Gulliver

No, it tends to be three years and under, and I don't see any reason to particularly change that. Again, we're in an environment where if we can make $2.4 to 2.8 billion, that's a reasonable requirement. It's very hard to call what the impact, say, in the UK two years out, of the pound having fallen dramatically – one assumes that the Governor will do some package of adjustments tomorrow. We could have inflation at 3% or 4% in the UK and actually – two/three years out – find that interest rates are sharply higher. So I don't really want to basically change a series of protocols that we developed over many, many years, and in markets in Asia-Pacific, where we've seen extreme moves happen much more often – actually, we've seen pretty extreme moves happen in the West. So, no, I don't think there's a magic bullet for this; we just have to kind of tough it out. The problem with magic bullets is the unintended consequences of what you didn't think through. So I don't want to build up a massive credit portfolio managed by a couple of traders; I'd rather basically get the relationship managers out to build up the credit portfolio.

Ronit Ghose, Citigroup

I just wanted to clarify a couple of points you've already mentioned. So, firstly on capital and buybacks, can you confirm if the buybacks – the shares will be cancelled, and if so, when?

Secondly, you've talked a lot about the upstreaming of capital potentially from the US, and I was looking at your Hongkong and Shanghai Banking Corporation legal entity, which generates most of your profits, and you've been paying up below 50% of earnings up to the holdco, and I'm just wondering: is there a reason why, given there's a large amount of capital that sits in your Hong Kong legal entity – your APAC legal entity – is there any reason why you're not upstreaming more out of Asia?

And linked to that, your NPLs are beginning to tick up, albeit from a very low level, in Asia. I just wonder if there's any kind of colour you want to add, or any – is there any sign of whether it's in state owned Chinese companies or oil and gas exposure in ASEAN? Is there any sign of things looking a little bit more challenging which may want you to hold back your pay-out ratio – your upstreaming up from the Hong Kong bank?

Stuart Gulliver

The shares will be held as treasury stock.

Ronit Ghose

They won't be cancelled?

Stuart Gulliver

No.

Ronit Ghose

Why is that?

Iain Mackay

There is no accounting, capital or any other benefit to cancelling them. There's no detriment to holding them as treasury stock, and in treasury stock it gives us some flexibility as to their future use and re-registration.

On the upstreaming of capital from Hong Kong, one of the reasons – and this will not be a shock to anybody – is that just as the rest of the world is implementing Basel III, so Hong Kong is implementing Basel III. And also, one of the other aspects is of all the markets in the world where we have reinvestment opportunity, the Asian markets is it. And so we have had historically a very consistent pay-out ratio – between 50% and 60% – from the Hong Kong bank up to the parent company, and at the moment that would seem to continue to be the appropriate thing to do. But the Hong Kong bank, to be clear, is really no different to any other subsidiary in the Group in terms of the challenge we place for the management team there around the efficient management of the capital.

Stuart Gulliver

Also, remember what we've just said is that we've sold Brazil, so we don't need the shares that supported Brazil, and we sold the sub-prime credit card business in the US and the upstate New York branches some time ago, and we don't need the shares that support those. We actually haven't sold anything in Asia that we don't need the shares to support any longer. So the pay-out ratios of the Hong Kong bank reflect a business as usual approach to dividends, as opposed to it holding capital that's the proceeds of things we've sold in the past.

Ronit Ghose

Sure, I get that, but your current capital levels in Hong Kong are in the mid-teens, and I'm just wondering if there's more scope to upstream there, or do you think that the current earnings will come under pressure in Hong Kong from rising NPLs and rising loan losses?

Stuart Gulliver

No, no. What Iain's saying is the HKMA – look at banks in Hong Kong. They have capital ratios in the mid-teens.

Iain Mackay

The regulatory capital management in Hong Kong is very much informed by dialogue with the HKMA around the implementation of Basel III and capital requirements within Hong Kong. There's a D-SIB buffer that sits in Hong Kong of 2.5% for HSBC. We obviously meet that requirement. But it's all about the quality of the conversation and the capital requirements informed by the HKMA.

Ronit Ghose

Got it. So there's nothing on the NPL side that's keeping you awake at night at the moment in Asia.

Stuart Gulliver

No, absolutely not. It's not – it's Brazil, Canada, US, oil and gas; it's not China.

Thank you very much. That brings the call to an end.