Edited Transcript
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Meeting with Analysts hosted by Iain Mackay, Group Finance Director

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On your net interest margin, what happened in the fourth quarter? When we were here after the third quarter you felt there was a measure of stability in the margin and the fourth quarter didn’t show that. And, actually, the second half was probably the weakest half you’ve had in the last several years, even adjusting for Brazil. So, I’m just trying to work out what drove that. And the disclosures we got on the day weren’t terribly helpful on that front.

Iain Mackay

The first time we provided real detail on net-interest margin was probably the first half of 2015. So, if we took the first half of 2015 and then roll forward, ex Brazil – these numbers are all ex Brazil. And if we look at where NIM was in the first half of 2015 ex Brazil, it was about 1.82%. And in the fourth quarter it was about 1.60%. The main contributors of that are in the United Kingdom, right? Approximately 17 basis points of that 22 basis-point reduction are reflected in the United Kingdom. That has contributed to much tighter competition from a UK mortgage perspective, certainly in terms of reducing UK mortgage yields in a very competitive market over the last two years. And that was perhaps most pronounced and the full impact of which was reflected in the second half of 2016. In terms of wider impact on UK term lending – so, across the corporate books as well – again, largely informed by fairly aggressive competition in the marketplace. There was an impact coming through there.

The other factor was the full impact in the second half of the year of the Bank of England base-rate reduction. The full effect was reflected in the fourth quarter. And I think in that regard, given where interest rates are, the ability to pass on any reduction of that to customers has been virtually non-existent. So, it has not really been reflected. Also, there’s been some compression on the asset side that’s not being reflected by any relief on the liabilities side of the balance sheet. So, really, the full effect is coming through in terms of net-interest margin.

And I think those are the main contributors to the reduction. Now, the other factors that come into that, which are somewhat less, is coming through from the North American business. And that is from the continued run-off of the US CML subprime portfolio, which contributed about 4 basis points of the difference. And as in previous quarters, we’ve got puts and takes from a net-interest margin perspective across the different jurisdictions as rates move and as we manage that through balance-sheet management. But the only other factor is the impact of TLAC over the course of 2016. And, as you know, we had just over $31 billion of TLAC out over the course of the year. Really, the full impact of the year’s issuance was reflected in the fourth quarter, although that in total contributed to 3 basis points in total.

So, the main contributor, when you look at it from a business and a jurisdictional perspective, is the United Kingdom, principally coming through mortgages; secondarily, coming through term lending into the corporate sector. The impact of the base-rate reduction in the United Kingdom – in the Bank of England rate. And then TLAC overall for the Group, and then within the US the CML portfolio run-off. So, if we factor in all those considerations into what NIM might look like in 2017, we would expect it to bottom out around the 1.55% - 1.56% mark.

Clearly, a number of the comments we made last week were that this would be the last year we have the headwinds of dealing with the US CML run-off. We’ve had anywhere from $300 million-$700 million of headwind coming through from the run-off of the CML portfolio over the last five or six years. We expect to substantially complete – we’ll still have about $300 million-$400 million of unpaid principal balance on the book by 30 June, but that will be all we’ll have on the balance sheet by 30 June. The rest of it we’d expect to be gone. So, we fully expect that there’ll be limited further headwinds, if any further headwinds, coming from the run-off of the CML portfolio, which has been one of the factors that’s had the businesses having to run particularly hard, which often, at a top-line level, looks as if we’ve been running hard to stand still in terms of generating net-interest income.

Those are the components. And the lion’s share of that has come though over the course of 2016.
Tom Rayner, Exane BNP Paribas

On the net-interest margin slide, then. So, the other thing there – you’ve sort of revised the interest-rate sensitivity to $1.7 billion. I think in the past – I think it’s possibly Stuart, rather than you, Iain – talked about an asymmetry as well with trading, booking of trading expenses and trading revenues. So, I’m just trying to get a sense for – if $1.7 billion is the NII sensitivity, what’s the total revenue sensitivity, sort of taking into account that asymmetry on the trading.

Iain Mackay

I wouldn’t try to predict where we go from a rates, credit, foreign-exchange trading – without having perfect insight as to what market volatility and market volumes are going to represent, Tom – is really difficult. As we explain in the Annual Report and Accounts, there’s an element of net-interest income generated through the trading operations and the activities of Global Markets, which obviously has some bearing, based on how the various currency curves move over a period of time, but I wouldn’t like to predict specifically the level of sensitivity, when you can’t predict the volatility or the volumes you are going to see through the main traded products within the balance sheet.

Richard O’Connor

Put it this way, our balance sheet management guidance is the same as the previous year – about $2.6 billion - $3 billion. So, that hasn’t changed.

Tom Rayner

In the third quarter we had this very low impairment number, and I think you guys were quite keen to point out that there were some fairly chunky write-backs in there. We’ve had another very low number in the fourth quarter. I didn’t sense this time there was the same scale of write-back. I just wonder if you could comment on whether we’re seeing a structural improvement in credit quality and whether, looking forward, the fourth quarter isn’t such a crazy number to think about as run rate.

Iain Mackay

I would never suggest that you take any particular quarterly number and annualise it as being a hard-and-fast guarantee of what it would be in the coming year. But where we are from a loan impairment charge is not by accident. There has been, over the course of the last five or six years, a very considered and focused approach to de-risking areas of the balance sheet. Whether it’s been us coming through the door in 2011 and thinking, ‘Hang on. There are parts of the business where we want to de-risk just against a risk appetite,’ or, as business has evolved, looking at the developments within those economies or those industrial sectors and saying, ‘Hang on a second. The level of risk that presents in those particular areas…’

And I think one of the areas that presented two or three years ago was the extent of exposures and some of the sensitivity within certain segments of the Chinese banking and financial-services sector. And the business set about, very systematically, reducing our exposures in that particular area. Again, that is a set of criteria that, from a risk-management perspective, we felt was the appropriate thing to do in terms of eliminating some possibility for significant volatility within the loan-impairment charges but, also, just recognising overall levels of indebtedness within a particular sector or a particular economy. And what we did in the Chinese banks was not dissimilar to what we’d done in the continental European banks in the 2009, 2010 and 2011 timeframe.

Another example of that would have been our focus on de-risking what had never been a particularly heavy area for us: exposure to commodities, for example, if you looked at some of the information within the appendix around what we’ve done around metals and mining and oil and gas. Although they both continue to be important areas of support to customers, how we manage individual customer exposures and how we manage those with respect to coverage from a collateral perspective and structuring of a transaction – or, in its most rudimentary form, just simply cutting limits is a thing we’ve systematically and thoughtfully done over the course of the last four or five years.

So, it’s not by accident – but I wouldn’t look at any given quarter charge and say, ‘Right, let’s just annualise that out.’ What I can say is that, consistent with previous quarters, Mark Sinclaire and the
team working with some of the insights that are provided by some of the internal stress-testing we do, take a very considered and very dynamic view of the extent of exposures we have in the book. And the goal is not to take no risk, but the goal is to avoid significant volatility and unexpected risk coming though the loan impairment charge line.

Richard O’Connor

In oil and gas, I wouldn’t annualise that. We’ve been about 30 basis points in the last couple of years. Obviously, it’s up to you how you project, going forward, but that’s sort of where we’ve been.

Gary Lam, Citi

Two questions, if I may. Firstly, on the US, clearly, you were sensing the potential of higher rates, maybe, and a widening margin of profit in the US and, also, potential deregulation in the States. So, to what extent would we start to revisit our appetite as to involve more into US banking or we decide to, ongoing-ly, sort of run-down more of that portfolio. What could trigger that sort of reignite that investment sentiment? Then, passing through to that, again on the manager’s income or manager’s margin kind of thinking, with the rising US… I think management – I think in the analysts’ briefing – monitored that UK, Hong Kong and US are the three key markets you can perceive to benefit from that rate environment. Can you maybe illustrate a little bit more as to the key angle to think about it? Is it by currency, by geographies? Or how do we better get it, on top of using your disclosure in the sense of the sensitivity charges parallel shift and the fundamental exposures that can benefit from these dynamics.

Iain Mackay

So, to be clear, we’re not running down the US business. We’re running down the US subprime portfolio. Across each of Retail Banking, Commercial Banking and Global Banking and Markets, the teams are focused on growing those businesses – but it would be fair to say that for the last number of years – and this remains the case to a certain degree or 2016 and going into 2017 – there is a very considerable focus on the part of the business in ensuring that we’ve got robust regulatory relationships in place on the foundation of strong regulatory command management – and that clearly has been a challenge for the US business for a number of years. But there is significant progress being made in that regard – notwithstanding the focus in each of Retail Banking and Wealth Management, Global Banking and Markets and Commercial Banking is to grow their business – and that is what they’ve done in each of the last two years.

When you think about rates sensitivity, again, as we set out on the pages in the investor deck, on page 13, the main blocks that represent – the main currencies that represent opportunity for us in that regard are US dollar and US dollar-linked, hence the US, Hong Kong and any other area where there’s a close correlation between local currency and rate movements with those of the US dollar. So, Singapore would be another. Many of the Middle Eastern countries in which we operate would be another. But that’s why it’s laid out in terms of currency blocks, in terms of how that represents an interest-rate environment.

When you think about the shape of our balance sheet, I think a lot of people in the second half of 2016 were getting excited about the steepening of the US dollar curve and particularly out at 10 years and beyond. That really doesn’t help us, and the reason it doesn’t help us is that our business is written at the 3-5 year or less, and therefore while some steepening of the yield curve helps, it helps a long time to feed through and has a much smaller proportional impact in terms of benefit to net-interest income line.

What really benefits us are parallel, upwards moves in the curve informed by policy-rate changes. So, when the policy rate changes by the Fed, that helps us. To the extent that we got a rate movement in December, that helps. That will represent, in terms of net-interest income, between $250 million-$300 million for the P&L in 2017. To the extent that we get any further rate increases from the Federal Reserve, that will also feed through. So, for example, if you get another one or two rate increases, if you took the year as a whole and you looked at it as 2018, that would represent somewhere between $500 million-$700 million of benefit to us if we got another couple of rate increases in 2017. The impact it would have on 2017 would be muted, based on when those rate increases came through.
Richard O’Connor

The other thing to say is, if you look at the chart on slide 13 on our customer lending, 61% is wholesale and 88% is variable rate. If you look at our mortgages, Hong Kong is all variable rate. And the UK is 50/50, but the fixed rates are all two-year fixed, so not really long-term fixed. So, it’s not just the term; it’s also the nature of the lending, which is primary variable-rate lending, as well, which is why we’re more base-rate linked than not.

Chris Manners, Morgan Stanley

Two questions if I may. Thank you very much for the NIM guidance. I think that was very clear. Sometimes what we’ve heard with other banks is we get the NIM guidance but find it very difficult to work out what’s going to happen to the earning assets. Maybe you could give us a little bit of colour about how fast you think you can grow your earning assets. Obviously, a bit more momentum in Hong Kong; Pearl River Delta is still there. I know we have some shrinkage in other parts of the Group. That would be really helpful.

And the second one is on GB&M. I thought it was really good, the way you now allocate RWAs to GB&M on a sort of client-facing basis. That’s easier for us to work out the true returns of that Group. I see you’ve basically got flattish RWAs at $300 billion. Is that something we should sort of grow, indexed to GDP or are there still more efficiencies you can get out of that business?

Iain Mackay

I’ll take your second question first. There is more to be done in Global Banking and Markets. One, we haven’t finished our work with respect to the original targets in Global Banking and Markets, so there is more to be done in terms of ensuring we hit the $290 billion reduction, of which $140 billion was represented by Global Banking and Markets. There’s more to be done in 2017. As we said last week, we absolutely expect to hit and exceed that target for the Group as a whole, and Global Banking and Markets will certainly fulfil their share of that target.

Going beyond that, there is an ongoing piece of work which, within the capital allocated to each business, represents a significant opportunity to recycle capital that sits within that is returning at a level that’s either below our threshold – and there is, as you can tell by our returns, a not insignificant proportion of capital operating below the thresholds we’ve set for each of our businesses and product lines within that. However, there is also a level at which we’re happy in terms of the overall capital allocation. So, the overall capital allocation to Global Banking and Markets was about a third of the total for the Group.

So, as you can tell from where we are to where we’d like to be, there’s still a little bit to be done, which we would expect to accomplish mostly in 2017. But, within that capital allocation, there is a recycling of capital from lower-returning assets to higher-returning. That’s made up of the customers to which credit and lending capital has been allocated. Are we getting ancillary revenue that was indicated at the time we underwrote those transactions? In some cases, no. And, therefore, are the RMs showing up on the doorstep and asking for that business? Where we’re getting it, that clearly helps. Where we’re not, then we’re taking a much more rigorous line around reducing those lines or eliminating those lines altogether, when they come up for renewal.

That work continues within Global Banking and Markets and Commercial Banking. There are good insights that the teams are working to turn that over. So, when we get to our $290 billion, we don’t expect to keep cutting RWAs, because we’re growing the business – but within that there is a churning of capital that we have to do to improve the efficiency of capital allocated to individual customer relationships.

In terms of growth, going to your first question, one of the areas that was encouraging going through the fourth quarter was the rate of growth we saw coming through not just mortgages but also corporate lending in the UK and in Hong Kong, most notably in Asia. Where, again, the opportunity to generate attractive returns is clear, is the returns generated by our Asian business. So, those are two key indicators, but if you go across to our Mexican business – much smaller in terms of impact on the overall Group’s balance sheet and earnings at this point in time; also, they had a great step forward in 2016 in terms of getting back on track in that regard. But they grew their business this year across mortgages,
across retail unsecured product, across the Commercial Banking business. So, Mexico is a market which we’ve said for the last couple of years it’s a market we want to grow in, and the team made great progress in growing across the various global businesses this year – and commensurate profitability with it.

The Canadian business – although it had a difficult year in terms of loan impairment charges and some of the restructuring within oil and gas and metals and mining – came out of the fourth quarter with good momentum, improved growth numbers coming through from a credit and lending perspective again. The area which continues to be challenging for us is, broadly speaking, the continental European business. Although we’ve got our French business doing quite nicely, it’s proving quite difficult. And the growth, to the extent we’re getting it, is sort of in the very low single-digit area. In Europe, the UK has been encouraging. Let’s hope that holds up. We’ll see how things go over the course of 2017 and beyond. Then, again, the Middle East and Asia are the two markets that have performed particularly well in 2016. And we expect that momentum to continue into 2017. In Asia, yes, we would expect the growth opportunity in the Middle East and North Africa to probably be slightly more muted that it was in 2017.

**Chris Manners**

If we add that all up, would that be low single-digit earning-asset growth?

**Iain Mackay**

Yes, you’re talking about 3-4%.

**Manus Costello, Autonomous Research**

I wanted to link the question about NIM. I had two questions, actually. There was one linking NIM and provisions, please. Given the pressure on NIM and given the very low provisions, is there any intention to shift the asset mix at all? I’m thinking particularly about moving into more retail unsecured, given that you’ve got rid of a big slug of it in Brazil. Have you got more appetite to take risk there?

Secondly, just following up on Mexico, I think your rationale a couple of years ago for holding onto Mexico was that you love NAFTA and NAFTA was a great deal. Some others seem to disagree, so I wondered if there was any change in your thoughts about the integrity of that American opportunity.

**Iain Mackay**

The answer to your first question is yes. I think what you saw on Mexico is one manifestation of that, but, yes, one of the focuses for John Flint and the Retail Banking and Wealth Management business is to take on more unsecured lending exposure across our businesses, whether it’s in the United Kingdom, whether it’s in the US or Mexico. But when I talk about unsecured I’m talking about Retail Banking product. We’re not talking about getting back into good old fashioned consumer finance, a la HSBC Finance Company or Household. But one of the areas John is focused on is changing the mix between the secured and unsecured in Retail Banking. So, there is appetite to do that. And that doesn’t, per se, require us to change our risk appetite. We’ve always had that risk appetite. It’s encouraging the businesses to use the capacity within the appetite that’s out there for them. But they are getting robust encouragement in that regard.

So, one of the things you will have seen in that linkage between net-interest margin and provisioning is that we saw expansion in Mexico but higher loan-impairment charges – by virtue of the nature of the product we’re underwriting. So, we would expect higher loan-impairment charges, but, on a risk-adjusted basis, be happy with the outcome from a returns standpoint.

**Manus Costello**

And does your NIM guidance that you gave us for next year include an assumption of a mix shift in there?

**Iain Mackay**

It would, yes.
Manus Costello

Not very much.

Iain Mackay

With upside opportunities – there’s not much in there. Okay, NAFTA. Look, we look at the Mexican business… Certainly, when you look at Retail Banking and Wealth Management in Mexico, we’ve got a branch network of more than 1,000 outlets, well positioned against the demographic that we like to serve. I think we represent about 11% or 12% of distribution capacity in Mexico, but represent about 6% of actual market share, when you look at it from an asset perspective. So, the opportunity to grow that business just to represent a market share that is consistent with our distribution capability in Mexico still leaves scope for significant growth within the Retail Banking and Wealth Management business.

On a domestic basis, we continue to bank commercial and corporates customers. We’ve got a number of very large corporates. However, a number of those corporates trading domestically also trade internationally, with significant trade relationships with the United States. So, there is a degree of uncertainty as to what that may mean for 2017 and beyond. I’m not sure, necessarily, that the construction of a wall across the border creates a problem for trade, but if there is protectionism rolled out as part of US economic policy then that clearly could have an adverse impact. So, the opportunity still sits there.

The Canadian, US and Mexican business, although they benefit from trade, one of the reasons we’re talking about NAFTA is that there isn’t a real NAFTA story that is delivered by any bank within the North American environment – and the opportunity to create value out of that is what we’re focused on. If that materialises on a cross-border basis, at least within Mexico, Canada and the US individually, there is an opportunity for the businesses to continue to grow, but the mix of the business would realistically be different, because the large corporates who trade internationally would have limited opportunity to do that – at least with the United States. But it remains to be seen, right?

There’s lots of debate around this, but it is… The adverse knock-on to the US community and the US economy of significant and severe restrictions on trade with Mexico would be felt, probably, more pointedly initially by US households than it would be Mexican, but who knows? It remains to be seen.

Rohith Chandra-Rajan, Barclays

I would like to go back to the interest-rate sensitivity again? The $300 million you flagged for this year from 25 bps, and the $500 million - $700 million next year from 50 bps, is a fairly linear relationship. If the rate-hiking cycle in the US continues, would you think that relationship would continue to be linear?

Iain Mackay

It’s not always linear because it kind of depends on the shape of the balance sheet across the different jurisdictions that benefit from US dollar rate increases. It’s not an entirely linear relationship, because, again, it depends at what point those rate increases come in, but we’re just trying to give you some guidance that gives you something to work with.

Rohith Chandra-Rajan

And is there a level at which you would start to be a bit more concerned about credit quality, or are we just too far away from that?

Iain Mackay

When you think about the jurisdictions in which those dollar and dollar-related exposures sit, the biggest dollar-related area is probably Hong Kong, and the credit quality within Hong Kong is extremely robust, whether you’re looking at the mortgage portfolio, whether you’re looking at the real estate portfolio, and wider industrial sector lending. The credit quality in Hong Kong is extremely robust.

When you look at the Middle East, the impact that we’ve seen in higher loan impairment charges, and probably more notably in 2015 than 2016, was as a consequence of reduced employment within the oil
and gas sector, and mostly from expatriate employees, which if they can’t pay their bills, they get thrown in jail, so they tend to skip out of the country when it gets close to the point that they can’t pay their bills. We had a lot of skipped loan impairment charges in 2015. So, again, from that perspective we would expect a relatively muted impact in that regard.

In the US, as well, particularly with the completion of the rundown of the household portfolios, again, specifically the mortgage portfolio in the US is a) very small, and b) very high quality.

Rohith Chandra-Rajan

On costs, on the regulatory spend. So the $3 billion you guided will peak out in 2017, but then not come down materially. That’s quite different, I think, from the way that you discussed it previously, when I think the rationale was the build phase.

Iain Mackay

So let’s make a differentiation here. The regulatory and compliance spend does not all relate to global standards, so anti-money laundering. Within that we’ve got implementation of the ring-fenced bank in the UK. With that being implemented, the implementation costs go away, right? Over the period from starting this to completing it in 2019, the guidance we have provided remains fairly consistent. We are going to be around – I think Douglas mentioned $1-2 billion. We are going to be somewhat in the range of $1.5 billion, slightly more than that, all in. That includes dealing with segregation of pension funds across the ring-fenced and the non-ring-fenced, and so on and so forth. But with that implementation complete, the dollars being spent on that day in, day out presently, goes away.

When you think about some of the stress testing, which is extensive across the different jurisdictions, we have built capability and continue to build capability, but are, in 2017 and beyond, beginning to see the benefits of some of the investment in technology and data quality improvements, where we absolutely expect to get some benefits coming through from that. Another one that sits in that space is IFRS 9, so when IFRS 9 goes live on 1 January 2018, although I’m sure there will be some post-implementation review costs, largely informed by the fact that the regulators will almost certainly want us to deliver a greater consistency than they presently anticipate – that’s an interesting one – again, significant costs being invested in the implementation of IFRS 9.

So there are a number of factors where implementation costs will drop away. I think when you listen to Stuart on this, his tendency is to refer to the global standards, and from a global standards perspective we’ve been building capability, and we’ll have to continue to improve, as will the entire industry, to improve our capability to do financial crime risk management across the financial system. We would expect that spend to peak in 2017; a great deal of that spend has been focused on implementing industry standard technology around transaction monitoring, for example. We absolutely do expect productivity from that over time, but it is over time, and until the DPA is wound up and the monitor leaves, I think it is reasonable to assume that levels of expenditure will remain fairly constant.

I think the DPA being lifted and the monitor leaving will mean that we’ve attained a state of progression in this where they’re certainly happy with where we are, and we would then be focused on delivering productivity, both from the technology and the overall processes. I think the timeline for getting significant reductions in that area are probably a little bit longer, but there are a number of programmes within the regulation and compliance space that on implementation spin off, we’d expect to see spend come down in that regard.

Rohith Chandra-Rajan

So just to make sure I understand, the $3 billion in total goes up a bit in 2017, and then starts to come down?
Iain Mackay

We expect to see the high-water mark in 2017, and then as some of these projects start to deliver productivity, or simply be implemented, then we would expect to see some of that spend drop away in 2018 and beyond.

David Lock, Deutsche Bank

Firstly, on structure, you’ve talked about HSBC France and potentially moving people over there as a result of Brexit, but I was just more thinking about the structure of the group. Because if I’m not mistaken, it’s currently a subsidiary of the Bank Plc which is also being split into ring-fenced and non-ring–fenced

Iain Mackay

That is correct.

David Lock

So will there be additional charges to restructure that into a separate European entity at some point?

Iain Mackay

No, because it is a separate European entity at the moment. What may emanate from European regulation is the requirement to set up a European intermediate holding company. We have numerous intermediate holding companies around the globe, and the cost of setting up an intermediate holding company to hold our European operations will be de minimis. The costs necessary to invest in the French entity to support any of our Continental European business post-Brexit, which is what Stuart has talked about in terms of possibly the need to move up to 1,000 employees to our French entity, simply to avoid conducting illegal business in the UK.

The theory is that on a Brexit, any equivalence we’ve got across MiFID, for example, would probably lapse, and there certainly would be – there is no construct today that would allow us to support a French, or a German, or a Spanish, or an Italian banking relationship from the UK business. We would have to do it out of a Continental European subsidiary, which from our perspective would be the French subsidiary. We own it 100%, whereas we’ve got minority shareholders within the German entity. And to simply move the UK – the French entity from underneath Bank Plc to under a European intermediate holding company, or in effect for the French entity to become the European holding company, we would expect to be de minimis.

David Lock

Then my second question is following on from that, really. When you set your capital targets, 12–13%, the world was a pretty difficult place from a capital allocation perspective, I would have thought, from a regulatory perspective. Now we have IHC in the US; we also have potentially an IHC in Europe. We have a more protectionist stance from regulators around capital. Has that changed the Board’s approach to how you are allocating capital within the business, or do you think that you will be ultimately running above that 13%, in the medium term at least, until you do have clarity on those items?

Iain Mackay

I think in the medium term we will be running somewhat above the top end of that range. Part of that is informed by the fact in the medium term – it’s going to take the medium term to get surplus capital out of the US, back to the parent company. The US entity’s holding a total capital ratio of nearly 25% right now, so to get that excess capital out of the US, back to the parent, requires us to, as I’ve said, make sure we’ve got the Bank in a status that is viewed as a good operating entity, sustainable, stable, by the Fed, the OCC and other regulators within the US. To some degree, also, it’s difficult to gauge exactly how much getting out of the DPA is probably a factor they’ve got in the back of their minds, and clearing other
industry-wide consent orders is probably another factor, on which good progress has been made by the team.

So over the medium term, yes, we would expect the common equity tier 1 ratio, the capital ratios for the Bank, to sit probably somewhat above the top end of that 13% range, by virtue of the fact that’s where we are now. Moving it significantly back into a lower level requires us to pull some of the surplus capital that sits in subsidiaries back into the parent company, to make it available either to grow the business, i.e. we can redistribute it to those entities that can benefit from that growth opportunity. Clearly a strong focus is ensuring long-term sustainability of the dividend, and then the other aspect is whether or not the opportunity exists, with regulatory approval, to do buybacks.

**Dominic Chan, BNP**

I’ve got a question on the net interest income sensitivity? It looks like, on page 13 of your PowerPoint, the NII sensitivity on your sterling block is actually pretty low, compared to the US. I’m just wondering why that would be the case. I would have thought that you would have a very strong correlation in the UK as well, but it doesn’t really show up in the balance sheet.

**Iain Mackay**

Sorry, it’s the sterling block that you –

**Dominic Chan**

Yes, yes. Because it says for every 100 basis point rise in the yield curve, your sterling net interest income will only increase by $51 million US, whereas it is $504 million in Hong Kong.

**Iain Mackay**

Yes, it goes largely to the structure of the UK balance sheet. So there clearly is a significant proportion of our business in the US – in the UK, sorry – is denominated in sterling, but there also is a wider mix of other currencies supported off the UK balance sheet. Again, it goes largely to the structure of the book within the UK that informs that sensitivity.

**Richard O’Connor**

Also on UK mortgages, as I say, it’s been mainly a two–year fixed, so obviously that doesn’t reprice in the one–year window which this disclosure gives us. So it’s a combination of factors.

**Claire Kane, Credit Suisse**

On the NIM guidance, so down to maybe 155 bps, is that where you see quarterly NIM troughing? I think if we take your NIM headwind guidance, so the UK base rate’s already in the Q4 NIM, and we’ve got the TLAC 500 million, which is around 3 bps. I am just wondering what is taking you down further to -5 BPS, and if we then see the benefits of rate rises coming through towards the end, so we go in a dip and we exit actually quite a bit higher.

**Iain Mackay**

So remember that incorporates the fact that we would expect to do another nearly $30 billion of TLAC this year. That is the main factor. And continued CML runoff. So those are the two factors that take us all a bit lower.

**Claire Kane**

But is it fair to say that that’s kind of taken all the headwinds and none of the mix benefits, or the rate rises?
Iain Mackay

Yes, that is right

Claire Kane

And then the second one, on the US. So you've referenced more than $8 billion of excess there. That seems to equate to around 14% CT1 ratio for that subsidiary. Is that the right way to look at it, 14%, or you think it could go lower?

Iain Mackay

It's not too far off the mark, yes.

Raul Sinha, JPMorgan

The first question, just to understand the VIU calculation, this time round on BoCom it's gone down, and apologies if I've missed it; I couldn't really find the explanation why it's down to $16.1 billion from $17 billion last year.

Iain Mackay

So it's largely informed by – so it lays out all the assumptions, right? But then assumptions are built onto expectations of performance within BoCom. And those performances of BoCom are grounded out by reference to historical financials that we get access to, but then also the market's view, so your guys' view of the performance of BoCom over that period of time. You've seen what the underlying assumptions are, what the sensitivity of the assumptions are, but the reduction of the, if you like, headroom to the $300 million where we presently sit is largely informed by performance factors within BoCom.

Raul Sinha

Okay, so it obviously wouldn't have escaped you that the run rate of BoCom profitability is well in excess of the headroom that you currently carry on an annual basis and on a quarterly basis. Just to think about when you do the test again, I think you will do it on a quarterly basis, wouldn't you? If there were to be, let's say, a rise in the VIU would we expect to have some kind of write-down in Q1.

Iain Mackay

No, if there was a rise in VIU –

Raul Sinha

There wouldn't be a write-down?

Iain Mackay

There wouldn't be a write-down, no. So as long as VIU is above carrying value, there's no impairment. So it's not a bright line. You could get to within a dollar of carrying value and in theory you would say, 'Right, there's no impairment required.' You could be a little bit below carrying value, and you could say 'There's no impairment required,' because it might be a temporary phenomenon. If you're below carrying value for a couple of quarters, you'd almost certainly say, 'Look, there's an impairment here,' and you would stop recognising our share of income coming through the P&L.

Raul Sinha

Yes. Well it's only $300 million, as you said, so that's not a lot relative to the quarterly profitability of BoCom.
Iain Mackay

No, it’s not.

Iain Mackay

So is your question around the accounting?

Raul Sinha

Is the right way to think about it, that actually it’s running really close to the headroom now, and you could be one quarter away from having to take an impairment on BoCom?

Iain Mackay

We could be, but I think this is the third year that we’ve seen we could be a couple of quarters away from impairment.

Tony Bloomfield

So you are right, the carrying value keeps increasing, the value in use has changed.

Raul Sinha

My point is, last year you were $17 billion on VIU and $15.3 billion on carry value, so there was a $2 billion headroom. It’s never been –

Tony Bloomfield

I have lived with this for two or three years. So firstly, one of the things that put the VIU down there is some FX in there, because it’s a renminbi calculation, so that’s part of it. But no, every quarter we do re-run the model. We look at the carrying value as well. That obviously just follows the accounting. The headroom has been this low before, but the VIU changes every single time. BoCom have done a lot of work on their capital, that’s part of it. They retain profits. They’ve been doing lots of other issuances. There’s many factors in there.

Raul Sinha

The second one was on the corporate centre. In the revenue line, you’ve got two lines that I was wondering if you might be able to give us a little bit more understanding of what goes through them. So one is the ‘Other’, which was $182 million negative in the third quarter, and then $43 million negative in the fourth quarter. Just to understand what goes through that line, if there’s anything at all that we should think about. And then there’s the other ‘Other’, including legacy credit, negative $456 million, just to sort of think about that.

Iain Mackay

The ‘Other’ tends to be inter-company noise through the consolidation process. That is really all that’s through that line. So it’s consolidation effects that, in effect, sit within the ‘Other’ line. And then, in ‘Other other’, if you like, there is the impact, there’s a – our corporate service centres bill through – so whether it’s the collection centre, the finance centres – bill through the corporate centres, so we’ve got charges out to our operating entities, and revenues coming back in as recharges. So there’s sometimes a timing difference of a net amount that sits within that. That is pretty much what sits within ‘Other’. There’s a number of headquarter expenses, if you like, operating expenses that come through, so whether it’s maintenance in support of the holdings board, other boards that some of the stuff that sits within the corporate centre. But that tends to be it.
Richard O'Connor

Just in terms of quantum, Q4 had about a negative $200 million, what you call ‘Funny items’, so I would not project those going forward.

Alastair Ryan

On the net interest income question for the UK, and it’s me not understanding. So based on quarterly data pack, which isn’t averaging any assets, its loans and customer accounts, margin’s up in the fourth quarter on the third. So what else is going on? And then also, to the question before, on the sterling rate sensitivity, and your comments are that sterling rates went down, that was material for the business. Why wouldn’t it be – what have you done in the UK so that it hurts you going down and it wouldn’t help you going back up?

Iain Mackay

So as rates go down, the ability to reprice rate sensitivity – On the way up, guess what? You’re giving part of that back to your customer. So the upward sensitivity is somewhat more muted than the downward sensitivity, based on where rates sit presently. The data pack is the UK only, which means it probably doesn’t include TLAC that’s coming through the corporate centre.

Richard O’Connor

That UK includes balance sheet management, which had a very strong Q4, which you saw from the corporate centre. So there’s a bit of volatility in it.

Andrew Coombs, Citibank

Two questions. One, I just want to follow up on something Stuart said on the call. He talked about a strong start in January in both GB&M and in RBWM. Perhaps you could elaborate a bit more on the RBWM side? Is it the Retail or the Wealth that’s driving that strength in January?

Iain Mackay

It’s been both, actually. So the momentum that they carried from Retail Banking in the fourth quarter carried on, and Wealth – the other aspect as well is, on a Q and Q, on a year over year basis, to get a better quarter in the first quarter of 2017 would not be an outstanding achievement on the part of Retail Bank Wealth Management, given the relative weakness in 2016.

Richard O’Connor

The 20F has more analysis in there of activity Bank Plc, so you can have a look at that this week.

Andrew Coombs

The second question is attached loosely to the NII and the NIM. You flagged that the majority of the decline was due to UK and in turn due to the mortgage margin pressure. If you look at your UK mortgage pricing, you’re at the lower end. You tend to undercut everybody else. In turn, when you speak to the brokers, they say it’s because you have to offer lower pricing because your application to offer rate is, on average, double everybody else.

Iain Mackay

Application to what?

Andrew Coombs

Application to offer speed timeframe, so it’s a service versus pricing debate. So you’re obviously slightly newer to the broker market, so with that in mind, operationally, what steps are underway to improve the
speed of the process? Is it something we should think will come down and therefore you could be a bit more of a price setter rather than a price taker?

Iain Mackay

Yes. So this is an aspect that’s unique to the broker channels. So if you do origination directly with HSBC, you can go through the application process now in about 30 minutes. It’s still probably, getting from – through the application process to the offer, it’s probably still a little bit longer than some of our high street competitors. In the brokerage channel, that’s extended a little bit further, just by virtue of the intermediaries sitting in the middle there. But there is – and Francesca and the team in the UK have done a lot of work over the last two years to significantly improve the service that backs up the mortgage offering. People look at the mortgage offering and like it, both in terms of construct but also pricing, but what we need to do is get the service offering that sits behind that into a more competitive position.

So the work continues. It has – from first-hand experience, it has improved significantly over the course of the last two years, but it’s still about four or five days adrift of the rest of the market.

Chirantan Barua, Sanford C Bernstein

Just a quick one on US DTAs. You said the household book is down right now, and we talked about tax changes in the US. How do you plan to monetise that, and is that DTA under risk? And if you could also remind me exactly what is the DTA out there which are linked to past losses.

Iain Mackay

Of our US DTAs recognised, the largest proportion is in the US. It is about $4.5 billion, which is the vast majority of the total. In terms of the anticipated planned profitability of the US business, the DTA per se is not at risk. The extent to which the DTA could be at risk, or if the US government decided to realise or pass into law a significant reduction in the corporate tax rate, depending on what that tax rate reduction might be, then it would put the DTA at risk. But then over time we’d get that back through the reduction in the corporate tax rate, at the point that you get to actually pay the taxes, which is further out in the timeline.

But right now, based on where we see the projects profitability of the US business for the DTA, we do not see it per se at risk.

Chirantan Barua

Ex-household, what would be the rough profitability of the US in 2016?

Iain Mackay

Well, look at what’s in the published accounts. Household has basically been a break-even business for the last three years.

Martin Leitgeb, Goldman Sachs

Two questions from my side, and it’s both a kind of bigger picture questions in relation to what’s happening in the world, and obviously in two aspects which would affect HSBC going forward, one being Brexit and the second being all the language around, whether it’s NAFTA, trade tariffs and so forth. Where do you see the biggest risk for HSBC going forward? Do you think more about revenue line, whether that’s a translation of sterling income as an example, lower trade finance volumes, lower investment, foreign investment in certain geographies, or the particular economies of particular parts of your business, where you think risk costs could be edging substantially higher? And how have you adjusted for that? You spoke about Mexico unsecured before. Is your risk appetite there now somewhat lower? Is there different hedging strategies you apply now for the sterling income? It’s a very broad question, I know. I’m just trying to get a better sense on how we should think about it.
Iain Mackay

What we do in the bank is trade and investment flow support, we cover 90% of global trade and investment flows across the 23 major trade corridors that we cover. Net, we operate in 70 countries. Again, 50 of those cover that almost 85-90% coverage of global trade. If there are a set of trade policies promulgated by various governments around the world that resulted in contraction of global trade, contraction of investment, lower levels of GDP, then that’s going to create pressures for a bank like HSBC.

If you look uniquely at what the US might do, then yes, it might adversely impact our US business. But when you think about trade in Asia, somebody will step into that, and the most likely person to step into it is China. The strength of our position trading across 22 different markets in Asia, where we clearly benefit from inter- and intra-Asian trade presently, and we’ve still got the strongest footprint in that part of the world, which has got the strongest growth profile around it, whether it’s from a demographic perspective, whether it’s from a wider economic and societal development perspective, we’ve still got the most important network, with the most important exposures to the most attractive growth markets in the world.

Can that offset broad–based trade reductions in other parts of the world? It can make a good swing of it, but that clearly, if you looked at the macro level, that’s where the challenge rests for HSBC. So having put huge amounts of effort into getting the US business on the right footing to support growth going forward, and that US business we’re now handicapped in doing so, whether because of the breakdown of NAFTA or the breakdown of US trade more globally, that would clearly create some pressures. I think if you go beyond the medium term, you find it incredibly difficult to believe that the US would take a sustained position in doing that, because the US economy has probably benefited more than any other economy in the world, although not in the round – there are clearly segments of that society that have been left behind.

But it would be difficult to imagine the US going to a long duration introverted trade war-type scenario. But if you saw an environment which saw real downward pressure on GDP, trade volumes, investment flows, then that’s a scenario that would create stress and strain across the network. But when you look at the strength within key regions for us, whether it’s GCC, whether it is Asia, there is real strength in those areas to support, not necessarily trade with the United States, but trade with other parts of the world.

Stephen Andrews, Deutsche Bank

Can I just come back to the US again? Because we had another year last year where, at the IHC level, you made no money in the US, and this has been an ongoing problem. Just specifically, your comments on greater appetite for unsecured lending, one of the problems you’ve had in the US retail business is your mix relative to your US peers has been very, very different, in that you haven’t been willing to do some of the higher-margin retail lending. Which is why, structurally, your profitability has been lower. Are you thinking about, ‘Okay, this isn’t working in the US. We need to reposition the business to look more like our US peers from a retail and commercial banking point of view?’ Or am I reading too much into that?

Iain Mackay

The US business – the Retail Banking and Wealth Management made money for the first time in ages this year in the US, and that is the early stages of a repositioning. So if you look at the Retail Bank, it is basically current accounts, deposit accounts, prime mortgages. You’re not going to make much money off prime mortgages, current accounts and deposit accounts and a small Wealth Management business in the US. So the team is focused on – to your point, as you say, Stephen – changing the mix within the US Retail Bank Wealth Management business, and then within the Commercial Banking business it is about supporting trade with middle market enterprise that trade internationally, not trading domestically. There is no reason for a middle market that trades purely domestically to bank with HSBC.
So that is where the focus has been for the business for the last 18 months to two years, and they’re making progress in that regard. The headwinds that could exist for that middle market strategy are if all of a sudden the US decides that they do not want to trade with anybody international. That is one of the challenges; that’s one of the challenges of the model as we are structured in the United States. The risk appetite exists for the US business to do more in the unsecured space, and the CEO of that business has started moving in that direction.

Richard O’Connor

Just on the filings in US GAAP, the difference to IFRS is about a $550 million charge in US GAAP, which we don’t recognise at the group level, so – and you can see that in the filing. So the business did make money last year, just under $600 million on an IFRS basis.

Stephen Andrews

I think at the results meeting, and around the results meeting, for the first time in 10 years the Group started seriously talking about M&A again, and you were talking about asset management. Just as a general figure, I know the capital management plan and the guidance hasn’t changed, but is it just asset management you’re looking at? Or is this now a more broader, ‘Okay, we’re back on the front foot, we can afford to do deals, we’ve got the capital to do it, so it’s just opportunistic as to what comes up and what might be interesting’? Or is it specifically focused on asset management?

Iain Mackay

Asset management portfolios is an area where we’re looking. It is probably the only area where we’re looking at the moment. There is still work to be done, clearly. We’re not at the terms level that we’ve targeted. There is work to be done within our businesses, whether it’s with respect to the overall profitability of those businesses, the efficiency with which they’re run and there is another aspect around ensuring that, in any business that we acquire, we are very confident around the financial crime risk management capability within that business. Until we’ve got some of those things bedded down, I think it would be fair to say that our focus on any acquisition is fairly narrow and, at the moment, it is on portfolios within the asset management space. Even then, it would be a very selective approach.

Steven Chen, Haitong International

I have two quick ones. First of all, you suffer from net interest margin, partly because of the UK mortgage war, but you have also started a mortgage war in Hong Kong. Are you worried that there could be some net interest margin pressure in Hong Kong?

Iain Mackay

There’s been competitive pricing in Hong Kong mortgages for the last 10 years. I don’t think it’s a new phenomenon, to be honest.

Stephen Chen

Anyway, the current mortgage rate in Hong Kong is much lower than, I think, one or two years ago, so are you worried about the net interest margin in Hong Kong? Will there be any pressure? That’s the first one. The second one is: have you started to do any analysis on the impact of IFRS 9?

Iain Mackay

Kathleen, do you want to answer the one on Hong Kong mortgages?

Kathleen Gan

I think it’s fair to say that there’s competitive margin pressure if you look at what some of the Chinese banks are doing, but our mortgages are a very profitable business and we’re going to continue to originate within our risk appetite and be competitive in the marketplace.
Certainly in 2016 net interest margin in that space was very stable.

Correct. If you look across the last three years, actually the margins in Asia have continued to remain relatively stable.

IFRS 9 programme started a couple of years ago. It’s mostly building models, technology deployment, lots of engagement with the regulators in this particular regard. We are doing lots of analytics. We won’t share any data on this until the second half of the year.

The revenue mismatch in the four quarter is quite a big item.

You mean on the bonds and the swaps.

Yes, the 740-odd. Is there not a case for making this a sort of adjusted item or significant item?

We’re looking more broadly at the accounting for own credit spread across the piece, because the lion’s share of this – part of it relates to some gapping out between the Libor and the OIS curve, on which the two sides of the two instruments are priced or revalued, but we’re taking a wider look at overall accounting for own credit spread, because obviously there’s the fair value and debt which, on the early adoption of that component of IFRS 9, will go directly to OCI, so cease to be a part of significant items, if you like. We’re looking at that more widely.

Could you offer some colour on your thinking on related-to-China exposure, the risk appetite? Perhaps one observation for Hong Kong/China exposure is that clearly the group has had growth, but we compare the growth dramatically in Hong Kong or the growth that you are achieving in onshore China, this growth pace has been slower than what the respective market growth had been achieving, so can you share some of the thinking as to how you see 2017 versus 2016, and how you address potential concerns that in these respective markets maybe are present and market share is reducing?

In Hong Kong, market share remains very consistent with previous periods, whether it’s in current accounts, deposit accounts, mortgage, corporate lending. Market share remains very consistent. That would be true both for the Hang Seng brand, as well as the Hong Kong Bank brand. In mainland China, it’s informed largely by finding those opportunities, whether it’s in the wider mainland China or Pearl River Delta, that sit within the risk appetite, recognising that there are areas of stress within the Chinese economy. There’s a degree of caution in terms of how we’re deploying capital across the various industrial sectors, but we absolutely expect to see growth in 2017, as we saw growth in 2016.

In terms of seeing a particularly accelerated rate of growth, I don’t think that is particularly likely. I think we’ve investing in the infrastructure within the Pearl River Delta. We’re beginning to see new product volume come through, mortgages grow, but we’re growing off a very, very small base. In terms of the overall importance of those numbers to the group or even for the region as a whole, it’s relatively small at this stage, but we do expect to continue to see growth coming through both Hong Kong and China. Kathleen, is there anything you would add?
Yes. I thought you were going to say that, actually, we’ve seen ourselves gaining market share in specific areas, like trade. On mortgages we continue to remain number one in the market. In China, our mortgages actually grew about 40% across China and, adding in Pearl River Delta, something in the region of 51%. Actually, in key products, we’ve seen ourselves growing market share. I’ll be keen to just understand the perception of why you’re saying we’re not growing in line with the market because, in most cases, we are actually doing much better than the market. I think you need to go down product by product as well to understand which area we are talking about.