

# Edited Transcript

## Annual Results 2016

### Post-Results Fixed Income Analysts Meeting

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**Corporate participants:**

Iain Mackay, Group Finance Director

Iain MacKinnon, Group Treasurer

Nick Turnor, Head of Group Funding

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## Iain Mackay

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Thank you for coming along this afternoon. I'm not going to spend a lot of time going through the numbers. I'm sure you've had a chance to take a look at them. The good things about this, from an operating-profit generation perspective within the Group, so what we call the adjusted profit before tax – which is really a reflection of each of our global businesses and our legal entities to generate operating profits, sustain our obligations to our shareholders and our creditors – remains strong. Year-on-year it's basically flat compared to 2015.

Clearly, there is a lot of what we call significant items. A very consistent application of this over the course of the last few years. The impairment of goodwill in Private Bank, as we completed restructuring and repositioning the Private Bank in 2016. We impaired the goodwill, which relates principally to the acquisition of Safra Republic Bank back in 1999. Share value on debt, it has been a common feature of the volatility coming through reported profits for the last few years. We have early-adopted the component of IFRS 9 that relates to that treatment. From 2017 onwards, that will go directly to OCI and bypass the income statement, so it will no longer be a feature of volatility coming through the income statement. Clearly, earlier in the year, the loss of \$1.7 billion on the disposition of our Brazilian business. We took a loss-making enterprise out of the equation as part of the wider reshaping of the Group.

Then, clearly, significant investment as part of the wider programme in terms of reshaping from our product, our customer offering, our technology capability – \$3.1 billion worth of investment in realising that sustainable outcomes for the firm going forward. That was part of what we announced in the investor day in 2015, of what we targeted as \$4 -4.5 billion of investment to realise \$4.5-5 billion worth of costs. As we've delivered on those programmes we've realised an opportunity for much better yield from those programmes, principally through the execution of them. Other programmes have been added, but the incremental cost savings that we announced yesterday, which will take us up to around \$6 billion, certainly at \$6 billion from an annualised-savings perspective, increased investment to realise that, but the increase is coming from principally greater yield from the programmes we've already got up and running in terms of the overall productivity from a technology perspective, from a process-reengineering perspective, how we locate the Group internationally, and the resources across the network.

Accounting for those things, a reported profit before tax of \$7.1 billion. I've been doing this for six years. That is the most significant gap we've ever had between those two numbers. It's comforting in some respects that four items explain it, and it explains it quite clearly – but nonetheless it is a significant gap.

The dividend covered from profit generation from the subsidiaries and through dividend flow from the subsidiaries up to the parent company. Again, strong reserve position within the Group, with distributable reserves of around \$42 billion, which again supports our obligations to our creditors, to our shareholders over the course of the next couple of years. In extremis, clearly our view is to not need distributable reserves to have to deal with such things, but it's reassuring to have it there in any event.

That's really where we are from a results perspective. I know we've got a number of pages here, which really takes you through more of what we're doing from our programmes with respect to MREL, which we now obviously have to call it, as opposed to TLAC. If I slip into TLAC vernacular, you'll excuse me for that one.

But obviously, from a balance sheet perspective, the heritage of this firm is a very conservative positioning around the balance sheet. When we think about capital deployment and you think about it in a risk-weighted asset context, \$857 billion of risk-weighted assets at the end of 2016. The lion's share of that, more than 70%, from credit. That's what we do. We do loans and advances to customers. About \$40 billion from market risk; a relatively small number from counterparty credit risk; and the balance coming from operational risk.

The concentration of risk within the business is really focused on credit. I think when you then tie that across to our experience from a credit-quality perspective, the overall allowances, the volume and shape of impaired loans, again the repositioning that we've done across the portfolios – the de-risking in particular segments and geographies – has led us very deliberately to this position, that we maintain a conservatively positioned balance sheet with high-quality credit positions across our businesses around the world.



I think, overall, there is a strong focus on continuing to optimise the balance sheet. We generally talk about that through our discussions with investors, with our regulators, around optimising capital management, but it's more than that. It's capital management, but also how we fund the activity and liquidity management within the Group. It's something Mark Sinclair, as part of Iain MacKinnon's team, and other colleagues spend a significant amount of time focused on.

We've given you some of the key credit metrics here. Common equity tier 1 above the top end of the range we targeted, when we talked about where we wanted to be from a regulatory-capital perspective in the middle of 2015. Clearly, a number of specific capital actions delivered in 2015 and 2016, along with the capital generation from operations, has got us to that point. Total capital ratio of 20.1%, leverage ratio of 5.4% – very significant progress against what we've been doing in terms of recycling and reducing overall risk-weighted assets – again, part of the capital efficiency. And liquidity coverage ratio of 136% and AD ratio of 68%.

Overall, the soundness and safety and stability of the firm remains very much intact. I think if we were to nuance that with what you often read in the newspapers, there is a strong focus within the firm on continuing to reinforce and improve our operating capabilities in areas like financial crime risk management, which, obviously, operating under a DPA (Deferred Prosecution Agreement), is one of the areas where we've invested heavily over the course of the last four years. We've made very significant progress. There is more to be done, but we're making progress, and we'll continue with that focus.

Looking at page 13 in the fixed income presentation, there is a little bit of a description of how we put MREL in the marketplace. Our recognition is that we've got an initial compliance point around 2019/2020, with the endpoint being 2022. At this point in time, there is no definitive guidance from any regulator in the world – and we are covered by many. There's reasonable clarity about the quantity required, reasonable, but it's not definitive, but not necessarily clarity about the specific characteristics of this in each market: the specific quantity required, for example, in Hong Kong or the UK, how exactly this is to be structured or how this would work in a resolution environment. Of course, our whole objective from a management perspective is to never find ourselves in a recovery or resolution environment.

But to get to the position – having not been a big issuer in the market and not having a requirement for this from a funding perspective historically – recognised that we needed to get that programme underway. We got that launched in the first instance in 2016. We got just over \$31 billion out there in the marketplace. I think as we worked through the programme over the course of last year, spreads continued to tighten. There's a very robust appetite for the various products that we put out there, but our issuance strategy was through the Holdings company. That's how we historically have put capital instruments in the marketplace, and we downstreamed those capital instruments to our subsidiaries or retained it as the Holding company, as the capitalisation of our operating subsidiaries and the Group has been required.

I think that, as we've issued it through Holdings, what we've then done is repositioned that in the subsidiaries, with a view to – in line with what guidance does exist – repositioning that in line, broadly speaking, with what might be a resolution requirement. We've also informed that by what the funding requirements – which subsidiaries can deploy that. We've got, as you can see in the AD ratio, a surplus of deposits around the world. The preponderance of that sits in Hong Kong and Asia. Nearly every operating entity we've got has a surplus.

Every material subsidiary we've got has got a surplus of deposits to loans and advances to customers, but, as we've positioned this funding in the marketplace, we've focused on two things: one, positioning around what we think the resolution requirements might be in an end state – but that's, to some degree, guesswork on our part – and, secondly, which of our operating subsidiaries can use that productively through the global businesses and then managing surpluses through our Balance Sheet Management team. As guidance comes through our various regulators, we may have to do some repositioning and restructuring of that, but what we're confident about is that the instruments we've put in the marketplace afford us the flexibility to do that in the normal course of business.

Page 14 gives you a little bit of a view of what we've done in 2016 and then how some of that plays through in terms of the maturity profile of some of those instruments. In terms of our expectations around

2017, we would expect to get somewhere in the region of about another \$30 billion into the market in 2017 and – to the extent we need to do any more to top up to what hopefully will be more clear regulatory guidance by that point in time – we would close out the programme in 2018 to the extent necessary.

A little bit more detail around the capital structure within the Group is on page 16 and page 17 which goes into that in terms of the common equity tier 1 make-up and how we see that developing through to 2020. Clearly, in terms of where we stand today in capital ratios, we're extremely well positioned from an endpoint perspective. We already are where we are, but clearly we have things like the capital-conservation buffer, the G-SIB buffer, for example, that will be phased in over the next few years, but, again, we've got that well covered in our capital ratios – not only at the Holding company level but in our operating subsidiaries around the world, to the extent that they are subject to those requirements also.

In summary, then, the strength of our network puts us in an incredible position to support and serve customers across 70 countries of operation across 23 main trade corridors in the world. We capture, through that network, a line of sight to somewhere in the region of 90% of global trade and investment flows.

The restructuring we have done around the four global businesses is supported by Operations and the supporting functions: Risk, Finance, Compliance and so on and so forth. The interconnectedness of those businesses, operating through the legal entities in each country in which we operate, I think has brought much more focus to the execution of strategy and the ability to deliver against the strategic goals that we've set out there. Our long-term goals remain unchanged. How we reshape and modulate the tactics to deliver against that will be, to some degree, informed by policy developments across different jurisdictions in which we operate, dealing with some of the geopolitical uncertainty and structural and regulatory change that continues within the industry.

The success we had in 2016, again, goes to the attractiveness of the product from an investor perspective. I think, overall, the work that's been done over the course of the last few years has been around refining and sharpening a much more granular approach to capital management and the efficiency of capital within the Group. There's been good progress in that. There is more to do, but it is a continuum – which we'll remain focused on.

### **Greg Case, Morgan Stanley**

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You mentioned specifically around capital optimisation around the Group. Are we to take that to mean just purely on the equity side, or should we think about that from credit as well? Obviously, you've got a lot of long-dated OpCo tier 2. To your point on excess liquidity and things like that, is there potentially something to do there at some point in time to kind of manage that down?

### **Iain Mackay**

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We look at this in economic terms, but I'll give you one example. On the back of structural reform in the UK we're going to have a ring-fenced bank and a non-ring-fenced bank. The ring-fenced bank is Retail Banking and Wealth Management, Commercial Banking and Private Banking businesses. It will have, based on the split of our balance sheet of HSBC Bank plc today, a fairly robust funding surplus. The non-ring-fenced bank, the large corporate business, will be well capitalised, but it will have more to do from a funding perspective. We could look at some of those instruments, for example, some of which are low cost, that may be an appropriate measure in terms of funding, whether in the short or longer term.

We look at this very much from an economic perspective, case by case. It's part of the wider discussion that I mentioned earlier around balance-sheet optimisation. Part of this is very much about capital; part of it is about the wider funding structure. From deposits, it's not at the low end. From a quality perspective, it's perhaps at the higher end, with differentiation across retail, with stability of those middle-market large corporates, but also then through the capital instruments and the senior debt that we've got out there.

We look at this very much from an economics perspective, obviously informed by regulatory requirements. We'll revisit this on an ongoing basis and we'll take decisions based on what we think is the right outcome economically for the firm.

## **Greg Case**

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Is the regulator particularly pushing you to reduce OpCo debt at all?

## **Iain Mackay**

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No, not at all.

## **Christy Hajiloizou, Barclays**

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You were referring – it's in the slides as well, but you also mentioned it – that a lot of the regulatory rules, particularly around MREL, are to be finalised. Perhaps it's just me, but could you just go through a couple of the areas or regions where you're expecting finalisation and anything around timing for that, whether it's the PRA (Prudential Regulation Authority) or the OCC (Office of the Comptroller of the Currency) in the US?

## **Iain Mackay**

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Sure, so I think the first environment in which we'll get greater clarity will be here in the UK from the PRA. They're working actively on this. I had a meeting with the PRA earlier this week, and this is one of the topics we touched on. They're very conscious that they need to and want to get guidance out there to help us, to help the industry position.

I think Hong Kong is getting there. The Hong Kong guys have signed up to be good team members. They're not conceptually particularly bought in to the whole TLAC, which of course is what it's called in Hong Kong, TLAC. But they're not, per se, conceptually bought into it, because when you look at the funding structure and the capital strength of the banking industry in Hong Kong and the degree of supervision which they've been under, from our perspective, in perpetuity, they've kind of signed up to it under the FSB Basel framework. I think they're going to get guidance out there, but it might take them a little bit longer to do so. My guess would be it's more likely a 2018 timeframe.

The jurisdiction in which it might become even more difficult to get finalisation is the US. We provided, as did many others, consultation around the initial proposal that came from the Fed about the treatment of TLAC, whether you could issue it through a local intermediary holding company, bail in, or whether it should be issued from the ultimate parent company and how it would be bailed in.

We provided feedback. The industry's feedback was broadly well received. There were some changes that were implemented on the back of that, but final guidance, with the 120-day review that Gary Cohn (Chief Economic Advisor to President Donald Trump) has been asked to do by the executive order and where that takes us – it's difficult to say. I mean, again, you would hope to get guidance in the timeframe of 2017. That one I'm probably a little bit less confident about.

Europe's the other interesting one. If you think about this in the context of a resolution, which is what MREL and TLAC is essentially about, we've got a multiple point of entry resolution strategy, because of our multiple legal entities, capitalised, funded, supervised, regulated locally. But we have three main resolution hubs: Europe, if you like, which today, the subsidiaries and branches operate as subsidiaries or branches of HSBC Bank plc. Our French bank is owned by HSBC Bank plc, as is our German bank. The branches operating in Italy or Spain are branches of HSBC Bank plc.

That's why that's the main European resolution hub. The US is the other. Canada is sort of a separate case; Mexico is a separate case. The US are not really interested about the resolution of Canada or Mexico. OSFI (Office of the Superintendent of Financial Institutions) is; CNBV (Comisión Nacional Bancaria y de Valores) is. But they are probably less aggressive regulators in terms of pursuing resolution plans – although we have done recovery and resolution plans for both those jurisdictions. Then Asia is the other one – and entirely appropriately, because our Asian businesses are, to all intents and purposes, owned by the Hong Kong and Shanghai Banking Corporation (HBAP). Our Malaysian sub, our Australian sub, our Chinese sub, the shareholding in Hang Seng are all owned by the Hongkong and Shanghai Banking Corp. The extensive branch network – our Sri Lankan branch, Indian branch; there's a Malaysian branch as well – it's a sub – that's all part of the HBAP construct.

Those are the three main resolution hubs, so getting guidance out of those three main hubs is what

would help us move forward. That being said, if you go below that main hub area, the local regulators are getting more interested in this topic. My guess is, in terms of getting jurisdictional specificity around how you are going to reposition TLAC, is going to take a couple of years to work through. But if we could get to broad-based guidance – on which we can continue to issue with confidence, pre-position with confidence over the course of the next 12-18 months – across those three main hubs, that would be extremely helpful.

### **Corinne Cunningham, Autonomous**

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Has the UK regulator confirmed that you are a multiple point of entry yet?

### **Iain Mackay**

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They are working towards that. I suspect, at the risk of demonstrating a little bit of cynicism, something for which I'm not noted, I'm not sure they will ever confirm to any bank what the resolution construct is.

However, what they clearly like about what we've done from a MREL issuance perspective is that they look at the Group and the complexity of the Group, and orderly resolution of the Group, in their view, can possibly best be managed in a resolution scenario – rather than having it splintering into lots of subsidiaries on day one – by bailing in MREL at the parent company. You can recapitalise the parent company and hold the Group structure together and then work constructively with regulators in Hong Kong, for example, or the Federal Reserve or the OCC in the US to realise an orderly resolution of the subsidiary entities either through disposition, through a bridge corporation or whatever that might be.

They like that issuance strategy of TLAC coming out of the holding company, because when you downstream it even then it has that binding effect. If you downstream it and you needed to recapitalise one of the subsidiaries, you could bail it in internally without necessarily having to go external, for example.

They like that. They kind of branded it, or we've branded it, MPE+, but have they confirmed? No, they haven't. I hope they do at some point, but I suspect – and to be honest it doesn't matter. It's semantics. Whether it's SPE, it's MPE, I'm firmly of the view – and our team that spends all their life working on this stuff and I would say those senior in the Bank of England with whom we work on this are increasingly convinced – that MPE or MPE+ presents, from a regulator's perspective, a much more resolvable construct than a single point of entry organisation. We'll see. Well, let's hope we never see, actually. The goal is that we never have to do this. I don't care about other people, but clearly we manage the Group to ensure we never have to do this.

### **Lee Street, Citigroup**

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On that topic, are there any impediments? Say you've deployed your TLAC capital down to your subsidiaries. How easy is it to then move it back up to the whole Group, to redeploy it back down to a different one, as you get more clarity on your MPE requirements or your requirements for your subsidiary, but it's not quite in the right places?

### **Iain Mackay**

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Within the terms that we've put around those instruments, our ability to redeem that and do an internal liability-management exercise – where HBAP could pay out and move that back up to the parent company and we could reposition that in Mexico or the US, for example – the conditionality in the terms and conditions around the product, internal liability-management exercise, our view is we've got a lot of flexibility to be able to do that.

### **Lee Street**

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If I was being cynical, say with the US, if you had put money down to the US, how easy would it be to get that money back out of the US? It always feels like it's probably more tough there.

### **Iain Mackay**

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Based on experience, it's not easy actually. But we're talking about equity which has been held there for very good reasons. The reasons are getting fewer and fewer and fewer, which is why we've talked about

an expectation, with a no objection from the 2016 CCAR and a dividend projected in the second quarter of 2017 as part of that 2016 CCAR – we'll put a 2017 CCAR in on 1 April. That will have an intermediate holding company dividend back to the parent company as part of the capital-plan proposal.

The condition we need to create to allow that free flow is probably not the most significant condition in the mind of the Fed or the OCC, but from our perspective it's vital just in terms of reputational repair in the US and more globally, get out of the DPA, to improve significantly the quality of the relationship with the Fed, the OCC, the CFTC (U.S. Commodity Futures Trading Commission) – all our regulators in the US. I think we've made huge progress on that. I think the US team is to be commended. The amount of time that Stuart Gulliver, that Stuart Levey, that Douglas and myself have invested in that, along with the US team, is beginning to pay dividends – not literally, but figuratively speaking.

We have consent orders. JP Morgan and everybody else has got these consent orders around foreclosures. The industry will not be allowed out of that until everybody has got one. We have been told by the OCC that we've satisfied all the requirements, but we don't expect to actually get that consent order lifted until probably July or maybe later in 2017 – maybe as late as the end of 2017.

We've got two or three of those. If you go back to the old CAMEL ratings, it's about moving up through the CAMEL ratings, building a strong level of confidence around stability, soundness, good management, strong compliance capability, good-quality regulatory relationships, a business that's generating profits with dividend-paying capability back to the parent company.

And just keeping on track to deliver those things over the course of the next couple of years will not only improve and accelerate our ability to get the trapped equity that's in there back to the parent company – but also, if there was a need to reposition, through internal liability-management exercises, we would have greater propensity to do so. As with any regulator, it's about confidence not only in the local management but in the Group. I think they have a great deal of confidence in the Group, but we've got to get the US legal entities on a better footing.

## **Greg Case**

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Just to quickly expand on that point and the point you made earlier around the Fed rules, if it does get finally allowed that foreign-owned banks will be able to do IHC externally, would you still prefer to do it internally to give you that flexibility or would you do some external?

## **Iain Mackay**

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I think our first option would be to do it from the parent company, but it would be nice optionality to have. In the US, the most robust capital market in the world, lots of ability to access that market, we actually have a legal entity there, a bank holding company, HUSI. It's not the top IHC, which is HSBC North American Holdings, which has been there for much longer than I've been around. But we've got a bank holding entity in there, which files its 10-K as HUSI, HSBC USA Inc. That has put product in the marketplace, senior debt for the most part, on an annual basis for a number of years.

We've got an entity with an issuance track record that's well accepted with US investors. To have that flexibility would be nice, from an intermediate holding company. Whether we could do it out of HUSI, that's clearly not obvious. We'd probably have to get the ultimate intermediate holding company rated, which it's not presently. But to have that flexibility of that facility would be a nice thing, but our intention is to continue to put it into the market from the parent company.

## **Nick Turnor, Head of Group Funding**

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Let me just add to that. I think one of the things we are very aware of is that at one stage we had 19 different issuers in the Group facing the market, and that was quite a complex thing for Bloomberg to accommodate, let alone investors. That's in the back of our mind, as well. There's a benefit to having a smaller number of issuers with a clearer curve in each and every currency.

## **Christy Hajiloizou**

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What's the latest on the disclosure requirements around things like pre-positioning from HoldCo issuance? Isn't there supposed to be improved disclosure around that?



## Iain Mackay

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It's part of the guidance that needs to be forthcoming from regulators.

## Christy Hajiloizou

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You're still waiting, okay.

## Simon Adamson, CreditSights

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I have a couple of questions. First, the statement in the annual report from the independent Monitor on the anti-money-laundering and sanctions efforts looked a little bit alarming, but I'm struggling to try and understand how serious it is potentially and what the consequences might be for HSBC from what he was saying.

Secondly, not a lot of banks are saying much about IFRS 9 yet, even though it's only 10 months to implementation. I was wondering whether there is any more you could say about the potential impact on P&L or capital from that.

## Iain Mackay

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The Monitor has been with us since 2013. I'm hoping he leaves in July 2018. And his obligations were to do an initial assessment report, which he did and which he delivered in January 2014 and then to do annual review reports.

The work he conducts is that he does detailed country visits, where he goes forensically, transaction by transaction, customer by customer, to assess the stage at which that jurisdiction has developed in terms of implementing the policy, the control framework and the technology that helps us, basically, screen our customers, screen our customers' transactions, and assess risk from a financial-crime risk-management perspective. That goes across terrorist financing, anti-money-laundering and a whole range of different risk assessments within that.

This year, we will have completed the deployment of the policy framework, the actual execution framework and the technology that supports that. We will never be finished fine-tuning and improving and embedding this, because the people that we're trying to deal with are continuously trying to change how they access the financial system.

As a bit of background, actually, there was a report done by the Clearing House in the US last week, which is the big eight banks in the US – who did a paper about the amount of money they are spending and their concerns around the effectiveness of financial-crime risk-management. A number they put in there is that, collectively, they spent \$8 billion a year on this range of activities, which is more than the budget of the FBI in the United States. But what their point was is that monitoring transactions at a transactional level is not the best way to detect financial crime. You need intelligent networks that connect, which is a point that we've been making for some time. However, we've got a standard that we've got to implement and that's what we're going to implement.

Each year, the Monitor does an update report, and that's informed on these country detail reports. The Monitor's staff is made up of former US prosecutors, and they do extremely detailed work. In each report, they provided us areas where, at a transactional level, they have said, 'These represent weaknesses in your controls.' Out of each report has come a number of recommendations, which the monitor has asked us to implement. We have systematically set about implementing those recommendations. We've made very good progress. And once they're implemented, they're validated – initially by our internal audit teams and then secondly by the Monitor – before there's a sign-off that we've put the right controls and processes in place.

That work continues, and we have made great progress against that. However, each time the Monitor does a report based on transactional reviews, he identifies things that we can do better. We've had three annual update reports, and in each of the annual update reports he makes observations, 'Yes, you continue to invest. Yes, you're making progress. But, yes, there's more to do.' That's where the comment in the annual report comes from. We're in the last year, in theory and hopefully in fact, of the

DPA.

Now, our work, which we do independently, is to engage very actively with the Department of Justice, at a prosecutorial level in the Department of Justice, to ensure that they are getting not only the Monitor's side of the story but what we've done. 'Here are the recommendations. Here's what we've implemented. Here's how it's been validated. Here are the outcomes. Here are the resources we've deployed.'

Stuart Levey, Stuart Gulliver, Andy Maguire and Colin Bell spend time sitting across the table from the DoJ, making sure that they get clear insight into what we're doing, how we're doing it, the progress we're making and what we still need to do. Our view, in the interests of – and this is not being hair-shirted; it's just being appropriate in terms of giving complete disclosure about the things that we're doing, the risks that relate to it and how we're managing those risks. That's why the disclosure's in there.

On IFRS 9, the programme is up and running. It has been up and running for a couple of years now. There are detailed models to be built; there is implementation at a global-business level, a country and a legal-entity level, which is all in process. We've been running a number of dress rehearsals. We're running our third dress rehearsal in April. And we'll start parallel-running on this in the second half of the year. As we get into that parallel run, we will have built a level of confidence around the data that is coming through these multiple forward-looking economic scenarios that we are required to run by the standard, which helps us inform credit risk trends from stage one to stage two to stage three.

As we go into parallel run, we'll have run the models on a number of occasions by that point. In the second half, we'll start providing not just disclosure about what we're doing, but the data. What does the transitional impact look like; what we think about ongoing trends as they relate to this.

Now, the interesting challenge around IFRS 9 is (a) the standard in itself, and (b) how it interacts with regulatory capital. What the Basel Committee and, at the moment, no regulator or supervisor around the world has really dug into and addressed at a guidance level is, whether or not there is a robust enough understanding at a supervisory level about interaction between volatility coming through IFRS 9 stage one and stage two development and then how that flows through to common equity, to the capital base.

There was consultation paper on this at the end of last year. Our response to that was, 'You have a means by which, at least until you understand how the standard works, to largely neutralise that impact on regulatory capital. You shouldn't allow, at least until you understand the interactions, allow this standard to adversely – or, for that matter, favourably – influence what you see going on in reg capital ratios. The basic essence of the proposal to neutralise was, today, the difference between expected loss and allowance for loan loss is deducted from common equity tier 1, tier 1, and the proposal was to use that mechanism to neutralise it. If EL is greater than AL, you continue to deduct it. If ALLL is greater than EL, then add it back. Is that a perfect neutralisation? Probably not – but it deals with the lion's share of volatility.

Then, as you have a greater appreciation over a number of quarters or, for that matter, a number of years, you get through a couple of credit cycles, does it require the standard-setter to go back and think about adapting IFRS 9 or can we accommodate it within changes to how that's treated for regulatory-capital purposes? Right now, other than just – we and the industry have an awful lot of work to get the standard implemented. What worries me – and worries me because I don't know – is how it's going to get dealt with through regulatory capital.

If you add stress testing into that, the whole point of stress testing is to create credit events and market shock events. The challenge with IFRS 9 in that is that it has the propensity to be highly pro-cyclical. As a hypothetical, if you took the reduction in the price of a barrel of oil in 2014/2015 and the impact that that had on European banks and you did your forward economic scenario modelling, the likelihood of the provisions that you had to take on stage one to stage two migration, I suspect, would have been a heck of a lot larger than the industry actually dealt with.

Now, the interesting thing is, over what period of time do the recoveries start coming back in? If you maintain your discipline around underwriting and credit management, over the lifetime of a credit the experience should be no different. This is accounting, right? But what you could see here is an

indication of significant deterioration, which could be the price of a barrel of oil, real estate stress – whatever it might be – huge spike in loan-impairment charges; that translates into regulatory capital. And then for it to build through the models and for it to come back in, over what period of time does that happen?

If you did that under IAS 39 today, you would – both through model-driven approaches but also judgment – you would take a view on individually assessed credits and collectively assessed credits, based on experience, what your model's telling you, what you're going to take in loss; you'd make provision for it. Then, as you realise that you've either restructured the count or, in actual fact, from a collective perspective you've booked too much, you would reverse that out. And that is highly judgmental, but informed by the credit-performance data you've got in front of you.

Although there will still clearly be judgements under IFRS 9, some of that's going to be taken away from you just by the structure of stage one, stage two, stage three and your modelling. And the fact the models don't align to regulatory capital models, that's a little bit more complex. You can't make this stuff up – anyway.

## **Greg Case**

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Could I ask about how you're thinking about future op risk RWAs – potential inflation there or is that a bit more of a broader subset of Basel IV-type things, more than necessarily something changing in the near term?

## **Iain Mackay**

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If I did a breakdown on our risk-weighted assets today, \$857 billion is the total of which credit risk is \$655bn, counterparty credit risk is \$62bn, market risk is \$41.5bn and op risk is \$98bn.

Now, just to give you a reference point, if you took that \$98 billion of operational risk capital and added up all the fines and penalties, customer redress that HSBC has had to deal with over the last six years, we've got coverage for op risk about nine times over or eight times over in that \$98 billion. Do I think we need more capital dedicated to operational risk in the firm, based on what we're doing around investment in what we've just talked about, financial-crime risk-management, the overall operating efficiency or effectiveness of the control environment, from booking a mortgage through to it showing up in the financial statements, where you can always get better, and we'll continue to invest in that? Continuing the mandatory training programmes across HSBC, making sure that our traders know what good conduct in the marketplace is, what we can do from a cross-sell perspective, product suitability and sales practices – there is an opportunity there. There should be, but I don't think there is. There should be an opportunity to take operational risk capital out of the equation.

Today, our approach to calculating it is the standardised approach, the average of three years' operating revenue with the standardised weighting applied to it. It's entirely probable the advanced measurement approach is going to be removed as an option. Most of the American banks have implemented an advanced measurement approach, because what you can then do is put KPIs in place and then you can activate around those KPIs to try to manage it, by improving your operating resilience, take some risk-weighted assets out and capitalise on that equation.

My sense is that that opportunity is probably going to be closed off to the industry, at least in the short term. The US banks don't like it; we don't like it; the continental European banks hate it. But I think that's the kind of composition that we're going to deal with in that regard. But, from our perspective, it is about the capital, but it's much more about reputation. When you screw up operationally, it hits your reputation. What it often translates into is fines, penalties and customer redress. It's about good husbandry; it's about managing the risks through your P&L. It's very much encapsulated within our risk management framework and the risk appetite that we set out, but there's always more that we have to do in this space.

## **Christy Hajiloizou**

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Can I ask about total capital? There were a lot of statements around your CET1 components staying at the high end of the 12-13%. Obviously, you have a requirement in terms of the AT1 and the tier 2 buckets.



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**Iain Mackay**

We do.

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**Christy Hajiloizou**

But I've never seen anything in terms of targets.

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**Iain Mackay**

1.5% and 2% – that's the target.

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**Greg Case**

Is that dead on or do you want to have a buffer above that?

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**Christy Hajiloizou**

That is exactly the question.

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**Iain Mackay**

Is there any merit to having a buffer on AT1s or tier 2s?

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**Nick Turnor**

It would be Pillar 2A, wouldn't it?

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**Christy Hajiloizou**

It includes Pillar 2A as well.

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**Iain Mackay**

We're sort of well covered from that perspective. I don't know. Somebody needs to convince me of the benefits of carrying a buffer on tier 2s and alternative tier 1s.

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**Christy Hajiloizou**

That's an answer. That's okay.

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**Iain Mackay**

Yes. And it might be the regulator that convinces me, but they haven't asked us to and they haven't actually had that debate yet, so that'll be one for the future.

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**Maciej Pisarek, Bank of America Merrill Lynch**

You've got the costs increasing on TLAC from \$0.4 billion to \$0.9 billion. What's the assumption underlying that in terms of the numbers?

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**Iain Mackay**

This is actually consistent with the guidance that we put out in June 2015. I think the guidance we put out in June 2015 was \$750 million or \$800 million, but the guidance is informed by what our cost experience has been with what we have done in 2016, kind of what we see in terms of market appetite and capacity going through 2017. It's not an extrapolation, but it's building on the fact that we did \$31 billion and we have an expectation that we'll do a similar number in 2017.

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**Maciej Pisarek**

Then on goodwill you've still got some left. Could you just tell us what it's relating to and what the risks are around that?

## Iain Mackay

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For goodwill – the total intangible we've got at December 2016 net is \$12 billion. It's not just goodwill. There are other intangibles in that.

If I go through a little bit of the history of goodwill, the top line there is \$12.3 billion. If I go back to when I joined the Group, I think we had about \$24 billion or \$25 billion of goodwill. In 2008 and 2009, we wrote off all the goodwill associated with the acquisition of Household. Until we dealt with the Private Bank Europe this year, any other goodwill that has been taken off the balance sheet has been because of dispositions and goodwill that was associated with the assets to which that disposition related.

What is left is there is goodwill left in Global Banking and Markets, and that relates to part of the acquisitions of CCF in France and Republic in the United States. I think that's the lion's share of those elements. Retail Banking, we've got goodwill associated with the acquisition of CCF, Republic in the United States and there's one other, but it's not a lot. It was the acquisition of the Indonesian bank BER, but it's tiny. Then in Commercial Banking there is virtually no goodwill associated with any acquisitions within the Commercial Banking space.

The goodwill in Global Banking and Markets is assessed on a global basis. It is run as a global business. It is highly interconnected. The revenues and the profits from the Global Banking and Markets business are used to assess the coverage of goodwill in that business. We have very healthy coverage and surpluses for Global Banking and Markets. In Retail Banking and Wealth Management, that's assessed at a regional level, so Europe and the US – and again we've got good coverage in that regard – very good coverage.

In fact, twice annually, we provide an assessment of those cash-generating units, as they are called, that may be sensitive to changes in the underlying assumptions of the profitability of the businesses.

The one challenge that we're going to have in Retail Banking and Wealth Management in Europe is around structural reform in the UK. We assess goodwill on Retail Banking on Europe. Now, when we put a ring-fenced bank in the UK, the question is: do we then have to assess it at the UK and at France? From the Group's perspective, there's not an impairment, but from a legal-entity perspective, could there be an impairment of goodwill either in the UK bank or in the French bank?

But, again, the regulatory treatment is the same: so no impact on capital, no impact on cash.

## Simon Adamson

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My colleague who covers a Chinese bank is interested in what you are seeing as the outlook at the moment for market conditions and economic activity. Have you seen a slowdown in the Pearl River Delta? How do you think your risk appetite compares with that of the local Chinese banks? Is there competitive pressure at the moment?

## Iain Mackay

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Our risk appetite is conservative by comparison to the peer group in mainland China. That is reflected, by one simple metric, in our credit costs associated with that. The operating profits in China this year, our Chinese entity – exclude BoCom – were about \$200 million lower this year, and that was informed less by revenue pressures and more by investments that we put into the business to grow the Pearl River Delta and investment in financial-crime risk-management standards in China.

It was more informed by the investment, as opposed to particular revenue pressures. There has certainly been some NIM pressure in mainland China, because policy rates from the People's Bank of China were coming down over the course of the year. But, overall, we've got a very consistent risk appetite. It is considerably more conservative than whether it's mainland Chinese banks or even some of the regional banks. We're probably positioned more conservatively in that regard.

The rate at which we've deployed capital into the Pearl River Delta has been a little bit slower by virtue of some of that conservatism but, also, just frankly getting greater insight with the passage of time as to how economy and growth rates and quality is developing specifically within the Pearl River Delta, but more widely in China. We provided, in the Appendix to the investor deck yesterday, some more detailed

background and exposures – global Chinese exposures, but exposures in China. The credit quality has remained very consistent over the course of the year.

## **Richard O'Connor**

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You get once a year, from the Chinese regulators, a league table of the foreign banks. And we are by far the biggest by any metric, but it's still less than 1% of the system. But, by profits, I would say we were well over 50% – and we certainly were last year. And I would guess we'd be higher this year, based on those who have reported so far.

## **Iain Mackay**

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In 2015, we generated profit before tax of approximately \$920 million in China. It's included in BoCom. It went from around \$1 billion to just under \$800 million. That is, as Richard says, the lion's share of profit generated by foreign banks in China. From a global-business composition perspective, that is largely Global Banking and Markets and Commercial Banking. We are building a Retail Banking business there. We've also got a co-branded credit card with BoCom, but we launched our own exclusively HSBC branded credit card in China this year, which got incredible take-up, which was good. Good credit quality coming through in terms of the early vintages.

We've built a high-quality mortgage portfolio in some of the main cities: Beijing, Shanghai, Shenzhen, and Foshan. Again, low LTVs, good credit experience – so it's a good business. Rates of growth are slower, but it is still growing – and it's still growing with attractive growth opportunities. I think the importance of China and the Pearl River Delta to the Group is paramount, but it is a tough place. I mean, there are clear restrictions on what foreign banks can do. A very clear example of this which we've talked about over the last year is that we have had an application in for majority-owned brokerage business based in Shenzhen. The licence has been approved at a central government level, but it's got to be approved at a regional level. And we've been waiting for that approval now for a year.

We'll get it. We've started investing in putting the infrastructure in place to build that business, but when you think about our ability to access and play a significant role in the capital-market development in China, we need that licence. We're being patient and doing the right things to get that. Samir is becoming more confident, as the weeks pass, that we should get that licence appointed this year.

It is important, but it is a tough place to do business. But the team is a Hong Kong Chinese team and a mainland Chinese team. The CEO of the business is David Liao. Young, incredibly capable – he's done a great job. His CFO is Singaporean Chinese. It's virtually entirely a Chinese team, so everybody speaks the language. They all speak Mandarin. Helen Wong oversees Greater China, so Helen's got responsibility for Hong Kong, Macau, Taiwan and mainland China. There's good connectivity across that. It's a good team, but it is a tough place to go and do business, with some of the restrictions on it.