Transcript
Q3 2017 Earnings Release
Conference Call with Analysts and Investors
hosted by Stuart Gulliver, Chief Executive and Iain Mackay, Group Finance Director

30 October 2017, 7.30am GMT
Good morning from London, good afternoon to everyone in Hong Kong, and welcome to our third quarter results call. We’ve made good financial and strategic progress since the half year and Iain will run you through the details shortly. Today’s call will focus on the numbers, but there is the usual slide on our strategic actions in the appendix outlining some of our achievements in the quarter. I will give a fuller update at the full year. I’ll now hand over to Iain to take the rest of the call, before we go into Q&A.

Iain Mackay, Group Finance Director

Our businesses carried good momentum from the first half into the third quarter. Third quarter reported profit before tax was $4.6 billion, up $3.8 billion, due largely to the non-recurrence of a number of large significant items from the same period last year, including the impact of the disposal of our operations in Brazil. Adjusted profit before tax of $5.4 billion was broadly stable, as higher revenue and lower loan impairment charges were matched by increased operating expenses, including continued investment in growth and higher performance-related pay. For the first nine months of the year, adjusted profit before tax was up 8%, and reported profit before tax was up by 41%.

Growth in loans and advances translated into higher adjusted revenue in our three main global businesses. Retail Banking and Wealth Management had a good quarter, with strong revenue growth from Current accounts, savings and deposits, and further loan and deposit growth in Hong Kong, the UK and Mexico. Commercial Banking benefited from another strong revenue performance from Global Liquidity and Cash Management, particularly in Asia. And Global Banking and Markets continued to grow revenue despite a challenging quarter for the industry, demonstrating the benefit of its differentiated business model. It achieved this largely through growth in Global Liquidity and Cash Management, Equities and Securities Services, which exceeded the impact of subdued market activity on our banking and fixed income businesses. We grew lending by a further 6% across all our global businesses since the third quarter of 2016, or 8% excluding our US CML portfolio and red-inked balances, mainly in term-lending and mortgage balances in Hong Kong and the UK. We have completed 71% of our most recent $2 billion equity buy-back as of 26 October, and we expect to finish by the end of 2017.

Looking quickly at some key metrics for the year-to-date, the reported return on average ordinary shareholders’ equity was 8.2%. The reported return on average tangible equity was 9.3%. On an adjusted basis, we had negative jaws of 1.3%, reflecting the increased investment in business growth in the second and third quarters, and we had a tangible net asset value per ordinary share of $7.29.

Slide 3 provides detail on the items that take us from reported to adjusted for both the third quarter and the first nine months of the year. The income statement for this year’s third quarter includes no gains or losses relating to fair value of own debt, whereas the comparable period in 2016 included a negative fair value movement of $1.4 billion. The reported results for last year’s third quarter also included a $1.7 billion loss on the disposal of our operations in Brazil, as well as higher charges relating to our cost-saving programmes and UK customer redress. The reported results for this year’s third quarter included $104 million of releases in relation to legal settlements and provisions. You’ll find more details of these adjustments in the appendix; the remainder of the presentation focuses on adjusted numbers.

Slide 4 breaks down adjusted profit for the year-to-date by global business and geography. Adjusted profit before tax of $17.4 billion was up $1.2 billion, or 8%, driven by higher revenue and lower loan impairment charges. Our business remains very well balanced, as the breakdown by global business demonstrates.

Slide 5 looks at profit before tax for the third quarter, which was broadly stable compared to the same period last year. Profits were up in three out of five regions. The reduction in Europe’s profit before tax was driven by higher interest costs in the holdings company, valuation differences on long-term debt and associated swaps, and the non-repeat of a 2016 UK bank levy credit in the Corporate Centre, and increased costs in Global Banking & Markets, including higher performance-related compensation. We had negative jaws of 4.9% in the third quarter.
Slide 6 provides more detail on revenue. Our global businesses maintained their momentum from recent quarters, growing revenue by $540 million, or 4%, compared with last year’s third quarter. I’ll go through each business in more detail over the next few slides.

Slide 7 looks at Retail Banking and Wealth Management, which grew revenue by 6% compared with last year’s third quarter. Wider spreads and higher balances in Hong Kong helped increase revenue from Current accounts, Savings and Deposits by $312 million. Income from investment distribution increased by $86 million from higher sales, reflecting the impact of renewed investor confidence. And we grew customer lending and customer deposits by 6% and 5%, following strong performances in Hong Kong, the UK and Mexico.

Revenue in Commercial Banking grew by 5% compared with last year’s third quarter. Global Liquidity & Cash Management had another strong quarter, growing revenue by 16% through wider spreads and balance sheet growth in Asia. Credit & Lending revenue grew by 1%, as balance sheet growth in the UK more than compensated for the impact of margin compression in Asia. Global Trade & Receivables Finance revenue was also up slightly, as growth in Asia and the UK more than offset the reduction from repositioning in MENA, and spread compression in Asia.

Slide 9 looks at Global Banking & Markets, which grew revenue by 2% compared with last year’s third quarter. This was a good performance in spite of subdued trading activity across the market, thanks in large part to our diversified business model and continued market share gains. Markets revenues were broadly stable compared with last year’s third quarter, as a 25% increase in Equities revenue all but eliminated the impact of lower Fixed Income revenues. Our transaction banking products continued to perform well from higher balances and higher spreads on deposits - particularly Global Liquidity & Cash Management, which grew by 19%.

Global Private Banking revenue was broadly stable compared with last year’s third quarter. We have now grown client assets in Global Private Banking in four consecutive quarters, and seen positive inflows of $13.1 billion in our target markets since the start of the year. Revenue grew by 7% in our targeted markets in the third quarter, particularly in Hong Kong.

Corporate Centre revenue fell by $220 million compared with the third quarter of 2016. The biggest driver was a $178 million reduction in revenue from our run-off US CML portfolio, as we all but completed the wind-down of the business. Balance Sheet Management revenue also reduced by $160 million. This is a consequence of repositioning activity and lower liquidity surpluses, as we grew our lending across the Group by $69 billion, or 8% since last year’s third quarter.

Slide 12 looks at net interest margin, which was broadly stable from the half-year. Net interest income of $7.1 billion was $137 million higher than the second quarter. Our net interest margin for the first nine months of the year was 1.63%, 7 basis points lower than 2016, excluding Brazil. This was mainly driven by lower asset yields, which reduced the year-to-date net interest margin by 5 basis points. This included a fall of 10 basis points, split broadly-equally between the CML run-off and the lower UK interest rate, which was partly offset by a 5 basis point increase, primarily due to loan growth in Mexico and Asia. The increased cost of debt had a negative impact of 5 basis points, primarily related to MREL issuance. Conversely, wider deposit spreads from higher interest rates, primarily US and HK dollar rates, raised the 9 month net interest margin by 5 basis points. There’s a detailed slide on NIM in the appendix, with more information on loan and deposit structures, and HIBOR and US Dollar LIBOR trends.

Slide 13 looks at operating expenses. We achieved a further $580 million of annualised cost savings in the third quarter, which helped support growth, and absorb the costs of inflation and continued investment in regulatory and compliance programmes. We had negative jaws in the third quarter, which largely reflects our decision to accelerate investment in business growth that we told you about at the half-year. We remain committed to achieving positive jaws for the full year.

Third quarter costs were $534 million, or 7%, higher than the same period last year, mainly due to increased business investment and higher performance-related costs. We invested $184 million in business growth in the quarter, mainly in Retail Banking & Wealth Management, which was partly funded by the sale of our shares in Visa Inc. in the second quarter. We plan to invest around $200 million more in growth initiatives in the fourth quarter.
Performance-related compensation rose by $324 million, reflecting the strength of our year-to-date performance. The remaining expense growth came from continuing enhancement of our Digital and IT security capabilities, marketing initiatives in Asia, and a small number of one-off expenses. We expect to spend around $400 million of costs-to-achieve in the fourth quarter, in line with the guidance we gave at the half-year. We remain on track to hit our targeted annualised cost savings of around $6 billion by the end of 2017.

Moving on to slide 14, loan impairment charges were $448 million in the third quarter, or 19 basis points as an annualised percentage of gross loans. Our credit standards remain robust, and the credit outlook within our portfolio remains stable.

Moving to capital on slide 15, the Group’s Common Equity Tier 1 ratio was 14.6% on 30 September, compared with 14.7% on 30 June. Our Common Equity Tier One capital increased by around $900 million, which included $900 million of capital generation from profits, net of dividends and scrip, $1.8 billion of favourable foreign currency translation differences; and the full impact of the $2 billion share buy-back that we announced at the half-year. Our 2017 Pillar 2A requirement is 3.5%, of which 2% is met by CET1. The increase of 60 basis points versus the 2016 requirement is mainly due to the reduction in risk-weighted assets between the end of 2015 and the end of 2016. Earlier this year we committed to update you on the potential impact of IFRS 9. As many of you are aware, we can’t give you the actual impact until it’s adopted on 1st January 2018. That will depend on changeable factors such as the size of our balance sheet, market conditions and forward-looking macro-economic assumptions – as well as our ongoing work on models, data and other improvements. However, recognising those constraints, our current estimate is that we will see an increase in loan loss allowances of around $2 billion before tax, which would impact our CET1 ratio by fewer than 15 basis points. Note that this is the fully-loaded impact and does not take into account any transitional relief that may be available.

Slide 16 looks at our Group return metrics. The return on average ordinary shareholders equity was 8.2%, and the return on tangible shareholders’ equity was 9.3%. You can see from the slide that the impact of significant items and the bank levy was to reduce returns by around 1.5%.

Our global businesses are performing well, and the strength of our global network continues to drive improving returns for the Group. Organic growth in revenue and lending is increasing, and we are investing more in the business to support this growth. We are committed to delivering positive jaws for the full year. And we remain a well-funded business with strong capital generation and a diversified balance sheet.

Operator
Our first question today is from the line of Tom Rayner from Exane. Please go ahead.

Tom Rayner, Exane
Two questions, please, firstly I guess on costs, I wasn’t expecting to be asking this, because I thought there’d be such a deluge of cost questions. Obviously it makes sense not to try to manage your jaws on a quarter-by-quarter basis and hence the negative jaws in Q3. Maybe we shouldn’t overreact, but I’m trying to get a sense. You’re obviously reaffirming positive jaws for 2017. Can you say anything about the jaws going beyond this year into 2018-19? I am conscious as well we have a new Chief Executive coming next year, so maybe that limits how far ahead we can look, but I just wondered if you could give us some update on your thoughts on jaws beyond this year, and then I have a second question on impairments, please.

Stuart Gulliver
I think you’re absolutely right that we also believe it makes no sense to manage a firm of this size and scale to jaws on a quarterly basis. We manage it to a much longer time series and clearly look at jaws on a calendar-year basis. We’ve recommitted that we’re working to hit positive jaws for calendar year 2017. Post 2017, it will again remain the case that the Group will be committed to work towards positive jaws. As you say, managing it on a quarterly basis creates a distortion. We have to invest for the future of the business and we had a number of investments into digital and so on during the quarter. We also had good strong performance in revenues in certain businesses,
where we needed to top up the compensation, which is a direct result of increased revenues. Yes, you need to think about jaws on a calendar-year basis and the commitment to positive jaws will continue.

**Tom Rayner**

Just on the impairment, if I asked you or Iain what the normalised impairment rate for HSBC is, you’d probably tell me 40 basis points, yet we’ve had another quarter of sub-20. I look at the gross charge and that’s running somewhere in the mid-30s, and releases at about 15 basis points do not feel like that’s a particularly unusual level of releases and recovery. I’m just trying to get a sense of whether normalised is changing or is likely to change at any point, given that you’ve derisked the Group. Underwriting standards I guess were changed post the financial crisis. We’re in a lower rate world. Your mix is different. Are there any thoughts about what ‘normalised’ actually means for HSBC, given everything that we know today?

**Iain Mackay**

We’ve debated this one with yourselves and the wider community at great length. You continue to see very stable credit performance across our portfolios this quarter, as you’ve seen over recent quarters. The underwriting standards across the businesses remain very consistent and you know the prudence that’s embedded within that. This quarter, we’ve got about 19 basis points LICs as a proportion of gross loans and advances, and the only area in which we saw slightly higher loan impairment charges was within the UK and, even there, it represented 18 basis points across loans and advances to customers. Across our portfolios, we’re seeing a very stable picture and, as in previous quarters, Tom, I’d very much guide the market to look at this performance over a number of years and certainly extend well beyond eight or twelve quarters in terms of getting a sense of what normalised credit costs are, which incorporate some of the changing conditions within the credit cycle. I won’t say this is guesswork, because clearly we have a very strong connection with our Risk colleagues across the Group, in terms of how we underwrite business and what the emerging trends are, but what I can say is we continue to see stable performance, both across the global business portfolio as well as the geographies.

**Ronit Ghose, Citigroup**

I just had a couple of questions related to margin, please. Thanks for the extra disclosure you’re giving now on margins. Can I ask you what was your exit run rate on the NIM? The 1.64% has gone down to 1.63%. Would it be closer to 1.60%, 1.61%, as an exit run rate?

**Iain Mackay**

Yes, that’s sort of right, about 1.61% coming out of the quarter. The key drivers, Ronit, across that were exactly what we described in the call here. We saw slightly wider margins on the liability side of the balance sheet, a little bit of compression coming through the corporate, both in Commercial Banking and Global Banking and Markets spreads, both within the UK and Asia to a lesser extent, continued margin spread on the mortgage product in the UK but, again, very, very muted, as has been the case in previous quarters. That has been largely offset by expanding net interest margin.

The other thing to take into consideration, which will be a dwindling influence in net interest margin, is the run-off of our consumer and mortgage lending business in the US. We’re now down to $300 million of unpaid principal balances. We would expect to see that gone by the end of this year/early next year, so the number of quarters in which you will see a negative impact on net interest margin from the CML business is pretty low now. I think it’s probably one or two quarters at most.

The only other feature that’s in NIM is slightly higher costs of holding company debt, as we continue to issue in line with regulatory requirements and guidance that we provided around minimum requirements and eligible liabilities. It’s a pretty stable picture from a NIM perspective and, if you take the holding company debt out of it, it’s broadly speaking margin expansion on the liability side and a little bit of compression on the asset side.

**Ronit Ghose**

If we took the holding company debt or the TLAC out, if you just looked at the liability spread widening versus the asset spread pressure, on the asset spread side how much of this is a mix effect versus, at a product-by-product
level, you’re still seeing asset spread pressure – i.e. you’re growing fast in mortgages, as you called out in your presentation deck. I’m just wondering if there’s, within the mortgage piece, a material front book/back book margin difference in the UK and Hong Kong. Similarly in corporate, in the Global Banking space you said there’s still margin pressure, including in Asia. I’m just wondering how much of this is at the product level versus asset mix level.

Iain Mackay

It’s pretty muted, Ronit. The difference between the UK mortgage front book and back book is pretty muted, with nothing of significance. When you look at the compression in that product, they’re literally talking about a couple of basis points, if that, in any given quarter. It continues to be an extremely attractive and profitable product for the Group, and the same is true within the Hong Kong and wider Asian context. The compression that we’re seeing in corporate lending again is in the single-basis-point-type territory so, broadly speaking, what you’re seeing is an offset between liability margins and asset margins in the round. There is no particular standout feature on any particular product within the Group.

Alastair Ryan, Bank of America

Two on revenue growth, please: first, it looks like volumes are broadening, so you’ve been a very Asian-driven business for the last few years. Is that fair? As mortgages start to kick in, in the UK, Mexico’s growing, the runoff’s finished in North America and you’ve got a broader front of volume growth than you had before.

Second, back to the net interest margin – and again thank you for the disclosure – I note that HIBOR started going up almost exactly when Stuart predicted it would and we may get a base rate rise in the UK. Dollar LIBOR is a bit higher every day. At what point, now that MREL issuance is pretty much done, should that deposit spread expansion be outweighing the asset spread compression you’ve discussed? Thank you.

Iain Mackay

From a revenue perspective, we’ve had pretty good spread across the different businesses and the geographies. As you see from our numbers, you’ve got good revenue growth coming through Retail Banking and Wealth Management. That’s informed by balance build, both in the UK and in Hong Kong in mortgages. Further afield, we see improvements also in the rebuild of our Mexican business. When you look at Commercial Banking and Global Banking and Markets, you have very strong performances in Global Liquidity and Cash Management across both of those global businesses and then, within Commercial Banking, we continue to see a build in Credit and Lending, with about 1-2% growth within that area. Again, that’s most noticeable within the UK, Hong Kong and mainland Chinese markets. When you look at Global Liquidity and Cash Management, again there is very strong growth in the first half of the year. Growth in the third quarter is more in line with the guidance that we provided to you at the half-year but, again, as we rebuild businesses, we see improvements within Mexico, within Canada, further afield within the Asian businesses looking away from Hong Kong and mainland China. Broadly speaking, as you work country by country, there’s good news in the vast majority of the markets in which we’re operating and certainly across the three main global businesses that we’ve referenced in the earnings release today, Alastair.

On net interest margin, you’re absolutely right in terms of improvement in HIBOR, which we’re beginning to see come through the deposit base in Hong Kong, as the gap between HIBOR and US dollar LIBOR tightens up. It’s not quite exactly aligned at this point, but it continues to move in the right direction. If one were to assume that we get a base rate change in the UK in the month of November, that would clearly translate positively into UK net interest income. Broadly speaking, if you thought about an increase of 25 basis points in the month of November, that would broadly translate into about $45 million worth of increased net interest income in the fourth quarter for the UK business, as an example.

On the MREL question, we certainly are in a good position but we’re not finished. We’ll continue to issue into the market when the conditions are particularly advantageous to us. As you know, we’ve had some very good outcomes from the issuance that we’ve done over the course of this year and the last. Broadly speaking, if we see a couple more rate increases from the Fed and we start seeing the Bank of England bank rate moving in the right direction, then the NIM expansion that we see in liabilities will more than compensate, we would expect, for some spread compression on the asset side and the cost of MREL.
Alastair Ryan

I have just one follow-up, if I may, on Balance Sheet Management. We would expect it to go down a bit in periods where, sure, rates are rising. That’s quite natural, but your famous $2.5-3 billion on a 12-month or a longer-term view – any comments, please?

Stuart Gulliver

I think we’re still looking at $2.5-2.7 billion for this year, for 2017. Next year, lower, so probably $2.3-2.5 billion or something around that. You’re absolutely right, Alastair; if you remember, as rates go up, Balance Sheet Management will make less because of the shape of the book. Commercial Banking and Retail Banking and Wealth Management will make more.

Rohith Chandra-Rajan, Barclays

I just wanted to follow up on the margin question. If I look at your disclosure, and I appreciate it’s relative to a parallel shift in the yield curve, but if I put through a 25-basis-point rise in US and UK rates, that would look like a $450-500 million benefit next year. I’m just wondering how much of that you think would be offset on the asset margins side.

Question two, just to clarify the cost guidance, so the $7.3 billion run-rate as we exit this year, is you’re talking about another $0.2 billion investment spend, I think in the fourth quarter. Presumably that $7.3 billion excludes the $0.2 billion investment spend.

Iain Mackay

On NIM, the broad basis of your interpretation around 25 basis points and UK and US rates is in the right ballpark, Rohith. In terms of how much of that may be eroded away on the assets side, it’s a pretty difficult one to guide on. It’s going to be very much informed by market dynamics and economic development. We’ve obviously within the UK market got an interesting couple of years ahead of us. Exactly how that translates into customer behaviour across each of our main businesses is really difficult to say, so I would be hesitant to give you any guidance on that point right now. I think you can be rest assured we’ll give you as much insight as we can on a quarterly basis, as we see the numbers coming through.

From a costs perspective, we’re very much targeting the exit rate of $7.3 billion at the fourth quarter on a constant currency basis, in line with the guidance. You’ve picked up that, obviously, what you add to that in terms of run rate is the bank levy, which this year and next year, broadly speaking, is going to be about $1 billion or slightly less. If you then think about the investment that we’ve done over the third quarter and what we’ve signalled for the fourth quarter, we are in a growing revenue environment. We have the capital available to support that growth and it’s clearly important that we maintain the investment around investing for that growth. Whilst in that environment, we’ll continue to invest across each of the main global businesses and the repositioning of our Private Bank. What you shouldn’t take away from this is that we’re targeting, in a growth environment with momentum, a flat cost picture. We will hit the exit rate that we talked about, we’ll deliver the savings that we talked about, but we absolutely will continue to invest to support our businesses. We’ll give you the guidance as we work through that, from a quarterly perspective going forward. You can see the $200 million that we’ve talked about; that is not included in the $7.3 million exit run rate that we’re referencing on our charts today.

Rohith Chandra-Rajan

I guess what you’re reminding us on costs is that we should think about positive jaws rather than specific cost numbers, as we go forward.

Iain Mackay

Yes, think about positive jaws and think about the positive jaws in the context of 1.5, 2 or 2.5 points, not 5%, 6%, 7% or 8% positive jaws. If we are in that kind of environment, we are clearly growing revenues. We will continue to invest in the capability of our businesses across digital, process efficiency and the product and service offering
to our customers, and the footprint that we’ve got. Positive jaws is absolutely what we would guide you to, but I would exercise a little bit of caution about going up into the higher digits in positive jaws, because that would certainly indicate a growing market, an opportunity to invest into that growth and to support that momentum.

**Manus Costello, Autonomous Research**

On capital first of all, I wondered if the increase in your Pillar 2A is going to be permanent, I would have thought, or certainly lingering for some time. When will you give us an update on your 12-13% CET1 ratio guidance? I know you said you would be above it for a period but, thinking about the 2A increase, presumably your stress test drawdown will go up as well, given that you’ve got lower RWAs as well. I just wondered if you could clarify what you see as the go-to CET1 ratio now.

On costs, my question was about the $300 million top-up that you put through in the quarter for compensation. I wonder why that did not come through in the first half. Why top up in Q3? Thank you.

**Iain Mackay**

Let me take the last question first, Manus. The adjustment to the compensation was really a reflection of the year to date. We strengthened our provisioning for performance-related compensation in each of the first, the second and the third quarters, and then spent some time with Stuart and the team looking at the overall performance through the first three quarters of the year and then adjusted accordingly for that, so there is clearly a component that addressed first-half performance, which was strong, and then reflects a year-to-date update in that overall scheme of things.

**Manus Costello**

Is there always something that goes on over the summer with that? Should we look out for Q3 being a point where there’s catch-ups on bonuses?

**Iain Mackay**

No, we should not necessarily. Perhaps what differentiates 2017 from the previous year is that we have had consistently strong performance. If you reflect on the third quarter of last year, Manus, it was a pretty tough quarter for our numbers, from an overall reported and frankly from an adjusted perspective. Our reflection on performance-related pay is exactly that; it’s related to the performance of the business, in terms of revenue and profit generation.

On capital, the Pillar 2A now takes the overall Common Equity Tier 1 regulatory requirement to 11.4%. We’ve been very consistent in terms of targeting a Common Equity Tier 1 ratio of between 12% and 13% and to the top end of that range. Sitting around 13% is a point and a half or so of buffer within the Common Equity Tier 1 space, of a management buffer over and above capital conservation, counter-cyclical, G-SIB and so on and so forth. We continue to have the view that around the 13% range, at the top end of the range from 12% to 13% is an appropriate place for us to have the capital.

Now, as I would bring out on the individual capital guidance in the updates to Pillar 2A, in actual dollar terms, the capital requirement has gone down and that is largely the rate increases informed by the fact that we have frankly been very successful at taking our risk-weighted assets down between the end of 2015 and 2016. The Pillar 2A is informed by an annual ICAAP. The ICAAP is built off the year-end risk-weighted assets position and, correspondingly, that significant increase between the end of 2015 and 2016 translates into a higher rate but, in actual fact, lower dollar requirement from an overall ICG perspective. That’s the take, but sitting above the 13% top end of the range, at this point, we clearly have a very strong capital position and even progressively bringing it back into the 13% range will continue to sit with a management buffer. Clearly, as we continue to improve capital management or risk management across credit, traded risk, operational risk and the other risks that are considered within Pillar 2A, it gives us the opportunity to work with our regulators to move those numbers both down as well as up.
Joseph Dickerson, Jefferies International

You’ve basically targeted about $500 million of investment spend in the second half of the year. How do you think about the return on that discretionary investment, in terms of revenue? Secondly, is there any offset to this from regulatory costs coming down? I noticed they were down about $100 million quarter-on-quarter in Q3.

Iain Mackay

In terms of investing, any investment decision is taken with a focus on the return on equity targets that we’ve set for the business and specific focus around return on risk-weighted assets and return on tangible equity within those businesses, and the opportunity to move that number north for the Group. A significant proportion of the investment that we’ve targeted in the second half of the year has been on Retail Banking and Wealth Management. There is a higher return equation within those businesses and, at this point in time, that’s where a significant share of the investment is going. The decisions are informed by return metrics on a project-by-project basis, within each geography and within each global business, and that’s certainly what the market would expect from an investment decisioning and capital allocation perspective.

In terms of overall regulatory costs, they remain broadly consistent across the piece, so reasonable stability within what we see from a financial crime risk management perspective. We would expect to see, as time moves forward, the marginal benefits of the productivity from a digital perspective within financial crime risk management, so we’ve deployed globally platforms around transaction monitoring and supporting KYC. Overall, as those become more embedded and finely tuned, we would expect to see some productivity, but it’s fair to say that, over certainly the next few quarters, it would be reasonable to expect broad-based stability within those numbers. When you think of some of the dynamics, some continuing implementation of regulatory requirements around the Basel III regime or CRD IV within Europe, continued embedding of the financial crime risk requirements, continued emphasis from the regulators around things like stress testing, solvent wind-down, recovery and resolution, and all of that expenditure, falls within the overall regulatory spend bucket. You will have a little bit of variability quarter to quarter but, for the next couple of quarters, stability is a reasonable position to reflect on.

Claire Kane, Credit Suisse

Could I have three questions? The first is to clarify the investment spend. Should we take the $400 million that you’re due for the second half of this year and just annualise that going forward? Is that the best run rate?

The second one is just to clarify the NIM commentary you mentioned. In terms of some of the allocation of the funding costs, I think you said you have a US CML drag but, overall, are we expecting funding costs to go higher from here? Even though you’ve had a negative in that division from the assets running off faster, will we actually see any benefit from that running away, if those funding costs just get allocated to other divisions?

Then my final question is just a follow-up on the capital. Earlier this month we had a paper from the PRA about group policy. I just wondered if you foresee any implications on your 13% target from the requirement to consider the local capital requirements of your main subsidiaries. On that, is there any update on the downstreaming of capital to the UK subsidiary? Previously you mentioned it could be $1.5 to $2 billion. Thank you.

Iain Mackay

I’ll take those in a reverse order. From a UK subsidiary capital requirement, the ring-fenced bank broadly speaking, based on our current understanding, the Common Equity Tier 1 requirements and overall capital requirements we would expect to be broadly consistent with what we’ve said from a Group perspective, so in the region of 12-13%. MREL requirements in the Group, you’ve seen the guidance from the PRA. At the local level, I think it’s two times Pillar 1 plus Pillar 2, or two times the leverage ratio calculated on a local regulatory basis. That again remains broadly consistent, maybe slightly higher, than the consolidated Group picture from an MREL perspective. Really, there is no change and no specific divergence as it relates to the UK main operating subsidiaries.

In terms of US CML impact and net interest margin, clearly we’ve got the higher-yielding assets running off and, broadly speaking, that will be down to zero by the end of the year or early next year. We do have some residual liabilities on that balance sheet, which we will manage over the course of the next two to three quarters, and
really have a clean and zero balance sheet from a US HSBC Finance Corporation perspective, I would suspect, no later than the middle of next year. It may have a couple of basis points’ impact, if that, on net interest margins from a cost of funding perspective, but not particularly significant.

Lastly on investment, annualising that is broadly speaking, in terms of working on the old spreadsheet front, probably not a crazy idea, but again the investment will be informed by the opportunity to invest for improving profitability. It will be informed by positive jaws so, when we’re in a growth environment, we’ll invest to support the momentum around that growth. Were that growth environment to reverse, then our focus will be on constraining costs, such that we continue to deliver positive jaws.

Stuart Gulliver

All of these investments are subject to a very detailed Cost and Investment Board process, so this money just doesn’t get easily spent. As Iain says, our attitude to expenditure will also be defined on how the overall operating environment is and how the firm is doing. From building a spreadsheet, yes, it may make some sense, but understand that we’ll reverse it pretty quickly if we need to reverse it pretty quickly, and no money is spent without us being able to see significant financial benefit to the Group.

Raul Sinha, JPMorgan

Can I ask you to comment a little bit on your UK loan growth appetite, particularly in the mortgage market as you’ve seen some decent growth picking up there? There’s clearly an expectation that the intermediary platform, as it comes online, will drive potentially higher market shares and maybe a bit more net loan growth than we’ve been seeing in that business in the past. Can you give us a sense of what magnitude of growth we should expect in this area? Against that, what do you actually view as the outlook for UK risk currently?

Iain Mackay

At the current time, the UK credit portfolios across the businesses are pretty stable. We talked about this a little bit earlier, so have nothing to add on that front. In terms of market share, at the end of the second quarter, we’re about 7% of the UK mortgage market. We’ve certainly grown into that during the third quarter, putting over $2 billion of new mortgage balances on. The underwriting criteria around that remain prudent. New business LTVs are at just over the 60% mark. The portfolio overall is 40%. As we continue to increase the number of intermediaries that we engage with, we’re now seeing about 68% of the intermediary market. In terms of the direct market, i.e. through the branch network, we’re probably about 20% of the market in that regard. Overall, we’re somewhere north of 7% now, so the profitability of the product, the overall risk positioning of the product in the marketplace and the pricing – it’s an attractive product. The new platform just went live, so we should see some benefits accruing from that as well, but the appetite for this product remains fairly well positioned within the Group. Again, as I say, it’s a prudently underwritten portfolio, but with good returns attaching to it.

Stuart Gulliver

There’s also quite a detailed slide in the appendix, slide 26, on UK credit quality.

Raul Sinha

In terms of the margin implications of that, can I assume that you’re very happy to trade off the attractive returns the UK mortgage product goes off against the fact that it obviously is going to be quite dilutive of the margin, from an asset perspective?

Iain Mackay

You’ve seen, certainly in the last couple of quarters, a basis point of net interest margin erosion emanating from the UK mortgage book, so it is absolutely clear that there is a lot of competition and plenty of liquidity chasing mortgage product in the UK right now. Notwithstanding some of that pricing competitiveness, this remains a very profitable product within the Group and within the UK business.
Raul Sinha

Can I just ask a second one on HIBOR? Obviously great call on the move-up, but I guess most of that move-up in the Hong Kong three-month HIBOR obviously was towards the end of the quarter. Can you talk a little bit about how that flows through in terms of net interest income within the Hong Kong business? Is the sensitivity here driven predominantly by the liability side or is there an asset-side kicker that comes in with the lag as well?

Iain Mackay

There’s liability benefit clearly. To date within Hong Kong that’s largely driven by US dollars, because we have a significant US dollar liability base in Hong Kong, as well as Hong Kong dollars and renminbi. However, the mortgage portfolio in Hong Kong is almost exclusively a variable-rate mortgage portfolio and, progressively, we’d expect to see rates move up and HIBOR reflected in repricing on the mortgage book as well. In Hong Kong, where we have a very significant, virtually all, of the mortgage portfolio as a variable-rate product, whereas in the UK, quite a significant portion is a fixed-rate product. We will see both assets and liabilities in the Hong Kong balance sheet, as you see over time greater convergence between US dollar LIBOR and HIBOR.

Natacha Blackman, Société Générale

I just have a quick one on funding. Would you be able to comment on where you are on your plans for this year? Particularly HoldCo Senior, and I assume you have no more AT1 and Tier 2 to do. Thank you.

Iain Mackay

We absolutely are on track in terms of meeting our goals from an AT1/T2/MREL perspective. What you’ll also have seen is, when the market conditions are particularly conducive from a pricing and from size-of-issuance opportunity, by different currencies in different markets, we’ve been happy to issue into that. As you’ll also have seen, the product has been extremely well received by the marketplace over the last few quarters. Our Treasury and DCM teams have done a great job writing into those markets. We will continue to approach the market fairly opportunistically. We know what we need to accomplish, broadly speaking, over the course of the next two or three years. If we can pre-fund at a particularly attractive rate, then we will continue to do so.

Natacha Blackman

Sure but, for AT1, are you able to issue if you’re doing a buyback?

Iain Mackay

We are not this year but, to the extent we would do any future share buybacks, we would look to find a way to possibly structure those such that, if the market were particularly conducive to AT1s, we’d be able to issue into it. Under the current share buyback scheme you’re correct; we are unable to issue AT1s while a buyback is ongoing.

Fahed Kunwar, Redburn

The Equities performance in the Markets business was exceptionally strong, particularly versus your peers. What products did you take market share or were there any positioning gains within that revenue line?

The second question was just going back to the jaws point. I think you talked about 3% jaws being feasible, going forward, and the consensus is around 4% jaws going forward. Is that still the right kind of positive jaws or is that too high or too low?

Iain Mackay

On the Equities front, we had a really strong performance in the Prime space, especially in Asia. That’s really the standout performance in the quarter on the Equities front. On a year-on-year basis that represents 25% up, but it was largely within prime and mostly within the Asian business.

On jaws, guiding to 3-4% is probably a little bit too sporty from a jaws perspective. I think you’re talking 1.5-2.5%. Again, in a growth environment, going back to Stuart’s comments earlier, where we see momentum around growth within our key markets, at an attractive returns level, then we would continue to invest into that and,
therefore, our behaviour on cost will be informed by generating positive jaws on an annual basis, but positive jaws of 1 to 2 points. Going beyond that, it really starts to question whether we’re appropriately investing in supporting growth in the business.

Martin Leitgeb, Goldman Sachs

I just have two questions, please. One is a follow-up on UK mortgages and one on Brexit. Just looking a little bit in more detail on mortgages, it seems like growth in the third quarter has accelerated from around 5% in the first half to around 9.8% in the third quarter. The implied share in gross mortgage lending is now at around 9% or even slightly higher. I was just wondering if you could shed a little bit of light on how much a step change the new platform will intermediaries will be in that mortgage origination, going forward. Once that becomes live, should we expect that gross share to edge up Meaningfully higher from the end of the quarter? Do you think that this might go double-digit from here, so I guess it’s low teens or mid-teens from here. The second question with regard to mortgages is risk appetite. As you mentioned, your loan to values in terms of new business are significantly below where the competition is. I was just wondering if you see there any scope to add a little bit more in terms of the average loan to values, or essentially should we think about the risk profile staying broadly stable from here.

The second one on Brexit is just a general question on whether you see any form of or any change in customer behaviour in the UK, whether that is on the corporate side, in terms of delaying some investment decisions in terms of less corporate loan demand, or whether that’s within the investment bank, where you see increased demand for using your French legal entity as a booking centre for continental European clients?

Iain Mackay

In terms of UK customer behaviour across Commercial Banking, Global Banking and Markets, perhaps as you would expect, there is a little bit of caution, but is it really showing up as a fundamental shift in change of behaviour or, for that matter, impact on the performance as to how that translates through to our business? The question is probably no. Is there a caution and a great deal of deliberation around decision-making by certain segments of our customers? I think that would be an accurate statement when we discuss either with Noel Quinn or with Ian Stuart, in terms of what they’re seeing in the UK customer base. Is it ground shifting? It is certainly not at this point in time.

Going back to UK mortgages, overall, we’re probably seeing market share around the 8% mark right now. In terms of the role of the new platform, clearly it’s facilitating mortgage underwriting and speeding up cycle times. That clearly we would expect to have some impact. However, what is more telling is the extent of market coverage that we’re getting, in terms of compounding what we see through the branch network with the number of intermediaries that we work with. Over the course of the last two years, as you can see, we’ve significantly increased our engagement with intermediaries. We’re seeing much more of their market, probably approximating or certainly approaching 70% of the intermediary market now. We’re seeing a greater amount of opportunities to underwrite within our risk appetite, which is one of the contributing factors to the continued growth in that product line. The platform will clearly facilitate that in terms of the interaction with our customers.

In terms of risk appetite, we’ve got a pretty well distributed book across the various loan-to-value ratios. Yes, obviously given the overall portfolio at 40%, we’ve got a higher proportion of lower-than-50%-LTV mortgages within the portfolio, but we also have segments going all the way up to 90% and less, from an LTV perspective. The pricing and risk management is reflected appropriately with that segmentation. Is there a broad-based opportunity for change within the risk appetite? I suggest probably not, given that we’ve continued to build market share reasonably successfully with a profitable product offering in the UK, with the appetite that we have.

That was our last question, so thank you very much for joining us today.

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