Transcript

Q1 2018 Post Results Analyst meeting
Meeting with Sell-Side Analysts hosted by Iain Mackay, Group Finance Director

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Corporate participants:
Iain Mackay, Group Finance Director
Richard O’Connor, Global Head of Investor Relations
Gavin Francis, Group Chief Accounting Officer
Kathleen Gan, Chief Financial Officer Asia-Pacific
Eva Law, Chief Accounting Officer Asia-Pacific
Alastair Ryan, Bank of America

Thank you. Good morning. Alastair Ryan from Bank of America Merrill Lynch. I suspect it’s probably the theme of the morning, so costs and revenues, quite clear guidance that your costs will grow by less and your revenues will grow by more over the balance of the year. That’s a relatively unusual place for HSBC to put itself - you’ve let the costs go early - so the question is what flex have you got on the costs if the revenues don’t come through, or what clarity have you got that the revenues are going to come through, given interest rate moves and so on, that gives you confidence of making that guidance? Thank you.

Iain Mackay

Good question, Alastair. To reiterate where we are from a cost perspective is we’ve got – if I break this down for you, we view the costs in three main categories. We’ve got ‘run-the-bank’, which is showing up, opening the doors, switching on the lights, operating from day-to-day. We have ‘change-the-bank’, which is investment to do as the name suggests: improve processes, products, technology platforms, digital. So it is investing in changing the capability of the bank. And the third category, of which we will incur, I would hasten to add, none in 2018, is costs-to-achieve. The reason it was called that is it was cost to achieve the strategic objectives we set out at our Investor Update in 2015. We completed those programmes in the fourth quarter of last year. There is zero expense in the first quarter of 2018 in that regard.

If I go to the first of categories of costs, ‘run-the-bank’ costs, our focus is on generating cost productivity across that category year in, year out. To give you a little example of that, we went into 2018, the first quarter of 2018 with a ‘run-the-bank’ cost run rate slightly below that of the fourth quarter of 2017 and the third quarter of 2017. It’s broadly in line with the first and second quarters of 2017. Where we saw the increase in 2018 in the first quarter was in the ‘change-the-bank’ category. These are discrete investments that we make. We set out a programme of work at our planning stage each year and then we flex that based on how we prioritise projects, how we see the revenue environment developing. That is the practice we sustained through 2017 and expect to stay with going forward – by that I mean if we see a revenue environment that continues to be supportive, we’ll keep on track with the investments that we prioritised for 2018. Should we see a revenue environment that heads in the opposite direction or stagnates, then we would look at those investments within ‘change-the-bank’ and reprioritise to manage the cost base such that we can generate positive jaws for the full year.

We initiated programmes in the first quarter or supported programmes in the first quarter that had been initiated in previous quarters informed by what we saw for the overall ‘run-the-bank’ cost profile for the year, the programmes we prioritised and the revenue that we saw coming out of 2017 into 2018. So just to repeat John’s comment, there is a commitment by the management team to deliver positive jaws for the full year. We would like that positive jaws to be in the range of 1%, which may be a little bit lower than we previously talked about and that is informed largely by what we see going through or what we’ve prioritised to go through ‘change-the-bank’ expense.

Claire Kane, Credit Suisse

It’s Claire Kane from Credit Suisse. Maybe just a quick follow up. Given that ‘run-the-bank’ is broadly stable and ‘change-the-bank’, and you’ve now guided to basically a stable quarterly run rate for the rest of the year, would you say that most of the initiatives in ‘change-the-bank’ have started in the quarterly run rate that we’ve seen in Q1 or are there more initiatives that are planned that then could be pulled back so you do have that flex? And then my second is on NII.

Iain Mackay

We have, insofar as ‘change-the-bank’ goes, beyond certain projects which we view as mandatory - meet certain regulatory requirements either with respect to reporting or reg reporting or conduct, for example - we view the projects as discretionary. So notwithstanding the fact that the vast majority of them have started, our view is that we could either slow them, scale them back or stop them. And it is again informed by our view that at the level of returns that we are presently generating, we need to be in a position that we’re generating some form of positive jaws each year, such that we continue to improve the overall efficiency of the bank and move towards – our view is that you can achieve a return on equity, a return on tangible equity without necessarily generating positive jaws but there is a question of pace. So within the ‘change-the-bank’ category, they are
focused both on improving productivity, which will come through ‘run-the-bank’, introducing new products or introducing or upgrading technology platforms that presently exist or new digitisation programmes, each of which we think and have experience based on last year and the year before can be reprioritised if we deem that as necessary.

Claire Kane

Great. My second question then is on Net Interest Income, which in Hong Kong was broadly flat quarter on quarter, so I guess a material reduction from the run rate in some of the previous quarters and so you saw much of the business growth offset by Corporate Centre. And I just wondered how we should think about BSM in Hong Kong, how that’s managed overall. Do you think this is just maybe a one quarter slowdown and we revert back to the growth trend previously or should we think about the BSM offset being quite material to the business growth here on in?

Iain Mackay

BSM is the mirror image of what we see primarily within Commercial Banking and Retail Banking and Wealth Management. The repositioning that we undertook in the second half of 2017 with respect to BSM, which was a step function reposition - we reposition the book virtually every day of the week - that a step repositioning in consideration of what we saw as higher interest rates coming through initially in US dollars. That’s largely complete. The step down that we saw in the first quarter I think is likely now to more probably represent the run rate of Balance Sheet Management overall. And I’d reiterate the guidance for Balance Sheet Management for the full year of $2.3 billion to $2.5 billion for the Group.

Richard O’Connor, Global Head of Investor Relations

Just to reiterate, Q1 v Q4, there’s fewer number of days. So actually the underlying NIM in the Hong Kong banking group was up 14 basis points from 1.88 for FY17 to 2.02 for 1Q18, so it’s still a positive trend there but, it’s masked by the number of days.

Claire Kane

Sorry, 14 basis points up on the NIM. And what is it, the NIM?

Richard O’Connor

202 v 188.

Robert Sage, Macquarie

It’s Robert Sage Macquarie. Just looking at the jaws, one of the things that strikes me on the revenue side is that when we look at the Retail Bank and the Commercial Bank it seems as if the commentary is suggesting that quite a lot of the improvements in revenues came through on what I would consider to be market sensitive types of items: so, insurance, investment distribution. I was wondering to the extent to which we should see this as being potentially vulnerable to future market developments and the degree to which we should expect to see these as being broadly persistent through the remaining parts of the year. Because in the past I’ve always tended to sort of flat line it. But is there actually a more firm, upward trend there that you see coming through?

Iain Mackay

It’s an interesting question, Robert. You have 100% of the revenue of the bank being market sensitive at some stage of the cycle but I think we most definitely see and have now seen for a number of quarters across Asia, perhaps more notably to some degree in Hong Kong is a confidence within the customer base around the willingness to put their what otherwise would’ve been very low interest generating deposits to work. And we’ve seen that across the volumes coming through the sale of mutual fund type products, other savings products, insurance products, orientated both on protection from a life perspective but also from an overall savings investment standpoint. Clearly to the extent that you were to see – and you see this coming through – the present value of in-force on a quarterly basis, there are market updates both which relate to the usual
assumptions that you see within an insurance business but also specifically with respect to the accounting for present value of in-force coming through market adjustments, principally within equities.

So, yes, there is also the propensity for some volatility within earnings progress that we’ve seen within Retail Banking and Wealth Management and Commercial Banking susceptible to market variation. However, certainly over the course of the last three to four quarters, we’ve seen a level of confidence coming through our customer base, most notably within Asia but not uniquely within Asia, which at least for the moment would suggest that that’s a reasonably resilient position for us to find ourselves in. But I would never suggest that our revenues are completely protected from economic change. They’re not.

**Tom Rayner, Exane BNP Paribas**

This is Tom Rayner from Exane BNP Paribas. Can I just stay on costs for now, please? Obviously 2018 is the first year without any significant below-the-line restructuring charges. I’m trying to get a sense that there’s no element of some of investment we’re seeing which might in previous years have been classified as part of the CTA. Second question on costs: are we likely to see a bigger impact of software amortisation coming through the P&L as we move forward over the next year or two? And the final one is really more of a jaws question. John said on the call the other day in response to a question, I think he’s happy to see negative jaws in areas of the bank where you’re experiencing growth. And I’m just wondering, if conditions improved across the whole group is that a philosophy you might extend group wide rather than trying to manage back to positive jaws at group level? Thanks.

**Iain Mackay**

So let me take the software amortisation one first. Pretty stable across what we’ve seen in the last four quarters and the next four quarters based on programmes that we have in the pipeline. And that is by virtue of the fact that, one, we’ve got a very conservative policy with respect to capitalisation of intangibles across our balance sheets and, secondly, to the extent that we see items previously amortised now reaching the point of full amortisation and that charge coming off. So notwithstanding the significant programmes that we executed over the course of 2015, 16 and 17, this step up in depreciation and amortisation is marginal - very, very small. And I mean, compared to previous years, a few tens of millions increase as opposed to anything greater than that. On the point around carry over programmes, there are a very small number of regulatory programmes that amount to very, very small numbers that are sitting above the line as ‘change-the-bank’ programmes, compared to costs-to-achieve that were occurred in previous years. Again, I’m talking about less than tens of millions. But we made it very, very clear to the businesses and the functions that they had to wean themselves off, or be weaned off, costs-to-achieve by the end of 2017. That’s been completed. In terms of any major programmes that are sitting within the ‘change-the-bank’ cost, they are largely new. So you imagine these programmes have a lifetime for execution as those completed – it’s a little bit like a funnel, as you would imagine with programmes that come in the top, they come out the bottom, they’re closed off. In terms of any programmes that are sat within ‘costs-to-achieve’, they were essentially completed by the end of last year.

On the negative jaws view, the commitment to positive jaws for the firm as a whole is absolutely what we are aiming to achieve. It is not our view to and it’s not our intention, as you can see from our numbers, to generate positive jaws every 12 weeks, nor is it our intention to turn in positive jaws by individual operating entities or by global businesses within the group as a whole, but to generate positive jaws for the group as a whole on a 12-month rolling basis as opposed to 12-week rolling basis. So that’s really what our intention is to achieve. We do have businesses, legal entities which are generating negative jaws principally because of their areas of investment for the moment. I would not say, based on all our discussions at this time, that there’s been an appetite for negative jaws for the group. I think circumstances would need to change significantly for us to undertake that.

**Richard O’Connor**

On the last point, there’s two other features. Clearly, in areas like Hong Kong, Retail, Commercial we’re under 30% cost income ratio. It makes sense to invest and not have positive jaws in areas like that all the time. On the converse, in mainland China, in Retail our cost income ratio is above 100 and we continue to invest there heavily and we’ll probably run with a high cost income ratio in China for a number of years as we invest heavily in the business. So you’ve got to look at it in a case by case basis.
Gurpreet Singh Sahi, Goldman Sachs
Hi, Iain. Gurpreet from Goldman. I have a question on Hong Kong. Going back to your comments last Friday on the green shoots developing in the asset pricing in Hong Kong, can you talk a bit more about which areas you’re seeing it, what is driving that, and then how does that build into the net interest margin outlook for Hong Kong? And then another one on Hong Kong, if I may, on the growth side. Last year was a very good year for balance sheet growth in Hong Kong, and this year has begun well. Assume it to be lower than last year, but then what kind of level would you see in your books? Would it still be double digit kind of a level?

Iain Mackay
I'll let Eva and Kathleen chip in in a moment, but when we talk about green shoots around pricing for assets, it is green shoots. I think it’s too early to say we’ve got a fundamental recovery. And I think that is going to be informed by the extent to which the liquidity position in Hong Kong supports rather aggressive competition in that regard. I would not suggest that we are seeing those green shoots within the mortgage pricing area at this moment, which remains very competitive but if in fact there is any recovery, it is largely within the corporate lending space. Kathleen, Eva, I don’t know if there are any particular comments you would add to that.

Kathleen Gan, Chief Financial Officer Asia-Pacific
Yes, it’s largely in the corporate lending space that we’ve been trying to price up and we have been pricing up in some jurisdictions: Hong Kong is one of them. But, you’re right, not in the mortgage space, trade even though it’s competitive, we have also have been able to price up in some instances, so it varies. But if you look at the margin, we’ve been continuing to improve on margin, quarter over quarter, since end of 2016. So I think from a margin standpoint, we are continuing to be in the right direction.

Iain Mackay
And on growth, again we’ve had a good start to the year, which is encouraging. Whether that necessarily connotes that that rate can be sustained throughout the year, we obviously have a reasonably confident outlook from a revenue perspective at this point in time. And obviously Asia and Hong Kong are a very significant contributor to the group’s revenue position, so overall a good start to the year and we’ll take it as it comes.

Richard O'Connor
Just two other points on Hong Kong - domestic Hong Kong GDP is 3-3.5%, so probably mid-single digit loan growth for domestic Hong Kong, albeit we’re doing much better than that on mortgages at the moment. But then think about Hong Kong’s role in China where you are seeing 10% to 12% loan growth in mainland China. Hong Kong as a booking centre for that, I would expect the corporate side and the international side to be higher than mid-single digit over a period of time. Clearly it can be volatile and has been volatile in the past but that’s how I’d think about it.

Dominic Chan, BNP Paribas
Hi Iain. It’s Dominic from BNP Paribas. I have two questions. My first question is on the Hong Kong funding costs. As you know, some banks in Hong Kong have been raising time deposit rates. I’m wondering what your thoughts are on funding cost pressure building up in the current year. My second question is on the UK loan pricing. Last year, the UK lending pricing has been going down quite fast than the funding cost decline, so I’m wondering what are your latest thoughts on that one as well.

Iain Mackay
If I take UK first, overall net income interest margin in the UK has remained broadly, broadly stable. We’ve seen a drop off a little bit and to the extent it’s been dropping off, it has been informed largely by mortgage pricing within the UK market. As we look at the UK market overall from a mortgage perspective, that continues to be a very profitable product for ourselves. It is conservatively underwritten. I think that is borne out once again by the results of the 2017 stress test in terms of seeing how our UK mortgage portfolio performs under stress. So though the pricing is fairly competitive in that marketplace, it continues to be a good margin product for us. I think there is one other aspect that came through net interest margin in 2017 and that was the impact
of some customer redress within the Commercial Banking business that was a contra-revenue item that had
the effect of knocking a couple of basis points off what we saw happening in net interest margin in the UK
overall. But to the extent we see any pressure there, it tends to be coming through the mortgage book overall.

From a Hong Kong funding perspective, obviously the Hong Kong market remains very liquid. You will have
seen last week that we increased the savings rate on US dollar accounts and there is some detail as to how
that is reflected across both time and demand deposits within the Hong Kong book and you can see that on
the website for the Hong Kong Bank. Clearly, given the movement in US dollar rates, it was appropriate to
reflect some of that in terms of how we pass it onto our depositors. And we felt quite strongly that it was
appropriate for the Hong Kong Bank to take a lead in that regard. Eva, Kathleen, I don’t know if we’ve seen
any moves by any of our competitors since Friday when we made that change. Perhaps you could comment
a little bit further in terms of the overall funding and cost of funds within Hong Kong.

Kathleen Gan
Yes, from a Hong Kong dollar perspective, the market is still very liquid and the aggregate balance is still very
high. The HIBOR- HKD savings rate gap has not widened enough to warrant HKD savings rate rise. As Iain
has mentioned, on US dollar we raised 10bps.

Jason Napier, UBS
Good morning. Jason Napier form UBS. Two brief ones, please. Just firstly on unsecured credit costs in the
UK. I appreciate the group bad debt charge was tiny, but in the deck, the arrears data that you present looks
stable. The book in sterling at least is stable. Is there anything to call out as to why that is the driver of charges
this quarter? And then, secondly, I appreciate the value-in-use calculation around the associates is model-
driven and who knows what might need to change but just on a mark-to-market basis, is there anything that
suggests that those are going to be revised higher during this year?

Iain Mackay
Okay, so on the latter point it’s not a mark-to-market model, it’s a discounted cash flow model.

Jason Napier
No, I appreciate that.

Iain Mackay
And I can’t under the current accounting conventions, I’m not sure there’s a mark-to-market scenario that
applies in that regard. It’s very clear where BoCom is priced on both A shares and H shares and, again, clear
where the deficit is, which is why we’re doing a value in use impairment assessment every quarter. The
disclosures on the value-in-use model and how it’s developed and how we revisit those assumptions is set out
in fairly lengthy disclosure with the Annual Report and Accounts. And nothing significant has changed in the
overall dynamic of that model. The impact of IFRS 9 as adopted by BoCom in the first quarter was considerably
higher – than our estimate was when they published those numbers. So, again, this is sort of a manifestation
of the fact that we are a minority shareholder and although we have a couple of directors on the board we have
no particular insight on the results much before those results are published.

So the higher than anticipated impact of IFRS 9 implementation in BoCom may well affect the overall carrying
value. Ironically, if anything it’s probably going to create a little bit more headroom between value-in-use and
carrying value than is presently the case. But when I say that, again we are talking about very small numbers
in terms of difference. So, look, the accounting model for BoCom has been applied consistently as has the
value-in-use assessment of it. We’ve talked now for a number of years about the fact that the headroom is not
significant and were there to be, for example, a significant slowdown in the rate of either revenue growth or
profit growth but a step up in the loss rate within BoCom, then it certainly could inform impairment. But how
an impairment is then accounted for, again, is set out in some detail so there’s nothing new.
Jason Napier

I read the disclosures. I just wondered whether there's anything in market rates and discount rates, as your interest rate cycle evolves.

Iain Mackay

It's one of those assumptions that we revisit on a regular basis. It gets revisited by us. It gets revisited by our auditors in terms of assessing whether the assumptions we've retained are appropriate and within a range that is appropriate for the outcome that is recorded in the financials. Nothing new.

Jason Napier

Okay. And in UK unsecured?

Iain Mackay

And on unsecured losses, it is informed by two markets. There's two markets on which we've grown the book from an unsecured retail lending perspective, Mexico and the United Kingdom. And at the moment, the higher rate of growth is within Mexico so the lion's share of Expected Credit Losses with respect to unsecured is coming through the growth that we see in the Mexican book and in much smaller proportion within the UK. But both are performing very much in line with our expectations based on the product we're underwriting and the type of growth that we're driving.

Richard O'Connor

And in 1Q17 in the UK, we had a modest benefit from disposal of non-performing loans so that's why it's spiked up year on year. As you say, the arrears are pretty stable.

Raul Sinha, JP Morgan

Morning, Iain. It's Raul here from JP Morgan. I have maybe one follow up from the call and then a couple of separate questions. On the separate ones, just on Hong Kong loans-to-deposits ratio, I think it's at 58%. Obviously there's a lot of discussion about the pricing environment and you're raising rates, clearly, but is there a broader point about that loans-to-deposits ratio moving as rates move higher, or do you think that you're going to protect that deposit franchise come what may, given it underpins so many other cross sell opportunity for the group in Hong Kong? That is the first one. Do you want the other two as well?

Iain Mackay

I can answer the first one. One, we'll certainly protect the deposit franchise because it's critical but sitting at 58%, that's still a very low AD ratio. And the fact that it has moved up from where it was at this time last year and the year before is a function of the growth that we've seen coming through both the Hong Kong and wider Asian markets, some of the larger credits denominated in US dollars often get booked on the Hong Kong balance sheet if they're emanating from a branch within the Hong Kong Bank, because that's where the strength of the dollar-deposit base sits. But the movement in ADR right now is largely a reflection of the growth that we've seen coming through and a reasonably stable environment with deposits overall.

I think overall the Hong Kong market remains very, very liquid. We're not necessarily seeing stress from a funding perspective in any currency, but the extent of demand for US dollar funding informs the fact that we just need to continue to manage the overall funding by currency with the usual rigour and discipline in each of the markets in which we're operating – and, frankly, Hong Kong is no different. But to see a slightly higher AD ratio is not concerning for us. It is informed by the fact that we've grown that book over the last couple of years at a reasonably good clip.

Raul Sinha

On GBM, Stuart used to talk about 60/40 seasonality first half/second half, but I guess that was a time when you had Balance Sheet Management in GB&M and that tends to be a little bit more seasonal. Now that you've taken it out, how do you look at the volatility of that business? And if I can ask you, also, given your more corporate-geared franchise, corporates tend to come and hedge a lot in the first/second quarter of the year,
and you usually find Q4 is weaker. So, do you think that seasonality still applies to GB&M given that Q1 this time around was a little bit softer than some of us were thinking it could come back?

Iain Mackay

Yeah, Q1... To the extent there was softness that we saw, we saw it in two product lines, to be clear: we saw it in Rates and Credit. Those are two product lines within the Global Banking & Markets business which historically have seen greater volatility. It’s informed as much by competitive pricing pressures and levels of customer activity. We tend, when there is significant volatility, to see less of the benefit, because we tend to take less aggressive positions in these particular product lines. There was very aggressive pricing over the course of the first quarter, particularly within the European market context. But across the other six or seven main product lines within Global Banking & Markets we saw progress versus the fourth quarter of last year and the first quarter of last year.

So, whether that was Foreign Exchange, Equities – the product lines within Global Banking – Global Liquidity and Cash Management, Securities Services – you know, good progress across the piece. And that has been reasonably consistent, again, for the last 8-12 quarters within Global Banking & Markets. Within transaction banking, we’ve seen great progress. Foreign Exchange reasonably stable – sometimes a little bit of volatility coming through that market, sometimes just very low levels of activity. We tend to see corporates tend to do more from a DCM/ECM and hedging perspective in the first 2-3 quarters of the year. I think there is an expectation that we’ll continue to see some seasonality within the Global Banking & Markets business as a consequence of that. But overall right now, Samir again remains reasonably constructive and positive about what his outlooks are for the year, notwithstanding the fact that February and March was a little bit slower than we saw in January.

Raul Sinha

Just the last one, to go back on what you just said a few minutes ago about the fact you think you can get to the 10% ROE target without positive jaws. And just sort of wondering if you can elaborate on that a little bit more, because the way I look at it, you know, you’ve got a very good credit environment right now, which is allowing you to report a pretty high ROTE. I mean, the 11.6% you reported in Q1 this year – you had 11.3% last year, for example, in Q1, and then the Group ended up only reporting in the nines at the full year, so obviously it’s going to fade. When we were in Hong Kong, we talked about how provisions can normalise higher from here. So, it seems to me that it would be quite hard for you to get to the ROE target if you didn’t have positive jaws, which is the point of the question as well.

Iain Mackay

I mean, it’s one of the reasons for maintaining positive jaws. We’ve got lots of levers that we can pull, whether it’s within the management of the equity and capital resources that we apply to the businesses, the cost management for the group overall – obviously informed by the extent and strength of revenue – and also maintaining consistency, and that’s what the Group has done now for 20 years. As I’ve been in this job, it’s consistency around the risk appetite. Whether it’s sitting within Credit, Market Risk, specific counterparty risk – there is a high degree of consistency. That degree of consistency has yielded very low credit costs for quite some time now. It is our expectation, because we’ve set a risk appetite that would be consistent with slightly higher levels of credit cost than we’ve experienced for the last few quarters.

Do I have any particular or special insight as to when we would see that normalisation occur? No. But there is an expectation that we will. But the likelihood of making a reported return on tangible equity this year is, I think, unlikely based on the progress we still need to make.

Raul Sinha

Can I ask what timeframe you’re thinking of when you said you could get 10% –

Iain Mackay

Medium-term, medium-term. I don’t think it’s five years away and I’d hope it’d be less than three years, but I don’t think it’ll be this year.
Manus Costello, Autonomous Research

Your UK Ring-Fenced Bank has got a big funding surplus. Would you ever think about any M&A activity to help fill that?

Iain Mackay

In the UK?

Manus Costello

There’s obviously stuff going on there.

Iain Mackay

Never say never, right, but based on where we are right now... I mean, if you just look at our market data on mortgages, for example, we have, I think, about 6.2% of stock in mortgages for the UK. And it is evident by the fact we continue to expand the proportion of the market we can see through the broker channel -- with adding another five or six brokers in the first quarter, we’re up to around about 30; we would expect to add a few more potentially as the year goes on -- we are of the view that we now cover about 75% of the broker intermediary market in the UK. The product that we’re originating through there which we do the underwriting and decisioning on, again, we think, fits nicely into our space.

There’s obviously opportunity to continue to grow in that area -- and to grow within a pretty prudent and robust risk appetite. I think what we’ve demonstrated to ourselves is that we are better at organic growth than we are at inorganic growth, without raking over the ashes of history on that particular point. And I think that would be our preference for how we deploy our capital and funding surpluses into the UK market is through organic growth. That would be our preference.

Would I... Well, I absolutely shouldn’t because we have talked to the marketplace about an investor update, and I wouldn’t wish to put words in John’s mouth. But I think it would be foolish for us ever to utterly discount the possibility of doing M&A in the form of portfolio bolt-ons, but I can say categorically that there is nothing that we’re contemplating at this time with respect to the UK market.

Manus Costello

Thanks.

Chris Manners, Barclays

Good morning, Iain, just a couple of questions from me, if I may, just on legacy conduct issues. DoJ -- you took the $897 million charge.

Iain Mackay

Not entirely accurate. $897 million in the quarter for litigation in the United States, a part of which was for the DoJ.

Chris Manners

Got you. So, I suppose, when we’re thinking about the DoJ penalty, can you give us an update on how you calculate that $897 million, what’s in it and how close you are to settling. I know that Ewen always gets that question every quarter and he does try to give us a little bit of an update.

Iain Mackay

In the round, there are two cases included within that provision in this quarter. Both are disclosed in note 34 of the financial statements at the end of the year. One relates to FIRREA1, which is a civil case being pursued by the US Department of Justice. It falls in the same category as the RBS case, the Barclays case, the Bank of America Merrill Lynch case, the JP Morgan case, a number of which have been settled. When you look at

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1 US Financial Industry Reform, Recovery and Enforcement Act
RMBS origination, we were sort of the tiddler in the pond when it came to the amount of activity that we did in that regard, which is why we’re probably at the tail end of the Department of Justice’s list of interests.

There has been no approach by the Department of Justice with respect to a desire to settle until the first quarter. We have entered into some settlement discussions with them, and based on the progress within those discussions we’ve set a provision. But as disclosed in the earnings release, we made a provision based on what we think it might be settled for, but that is by no means a guarantee that that is where it’s going to settle; it could settle for more; it could settle for less. So, we’ve made a provision based on our best estimate of everything we know at this point in time.

The other case that is now settled was with a counterparty to the mortgage-based origination business in the finance company, HSBC Finance, otherwise known as Household International. And we entered court-requested mediation talks in the first quarter and have now reached a settlement within that counterparty, again in a civil case.

Our legal counsel is working through a long list of matters that have to be closed out and have clearly, over the last couple of years, made progress. If we can get the FIRREA case settled within the next quarter or two, it would be a big item off the list for us.

Chris Manners

Thanks, so it’s fair to say you’ve provided as much as you think for FIRREA, so you settle, press release, no more charges.

Iain Mackay

Don’t know. As we say in the press release, it may be more; it may be less. It may be exactly the amount we’ve provided for, but since we haven’t told you the amount we’ve provided for, how could I comment further?

Chris Manners

Okay, fair enough. Could I ask you just a follow-up question on PPI just to remind us where we’re provisioned, whether claims are coming in, if we’re done on that?

Iain Mackay

So, the step-up… We have maintained since day one a very, very consistent approach to PPI, which is informed by the flow of incoming claims, the uphold rate and the payout rate that we experienced with our customers. So, in terms of where we are provided right now, we think overall we are probably at the upper end of the level of coverage in terms of overall claims coming in. The provision in US dollar terms as at 31 March was 1.3 billion US dollars in total for customer redress, of which the vast majority was PPI; $1.1 billion was PPI.

The provision in the quarter was informed by higher inflow of claims, reasonably stable uphold in payment rates – uphold is slightly higher but the payment rate is consistent. We’ll continue to monitor the weekly, monthly flows that we see coming in, how many are upheld, how many are paid out, what the payment rate is. We certainly think we’re adequately covered in this regard, but it’s an area of quarterly scrutiny both by ourselves, obviously, and also by Pricewaterhouse Coopers, our auditors.

Chris Manners

Thank you.

Winnie Wu, Bank of America Merrill Lynch

Thank you very much. It’s Winnie Wu from Bank of America Merrill Lynch. Two questions. First, regarding BoCom, we’ve seen the Chinese banks doing another round of recapitalisation, the most recent case being Agricultural Bank of China. And because most of them are trading significantly below book value and they can’t raise money below book, so the common choice is private placement.
So, you know, I know BoCom announced a convertible bond plan, but that doesn’t help capital any time in the next 12 months, so if BoCom is going to do any private placement which will be at a price that’s significantly above its current trading price, what would HSBC’s stance in this case? You know, would you be willing to participate either at a substantial premium to the trading price or are you comfortable getting diluted in this case?

Iain Mackay

You know I can’t answer that question. Why would I comment on a hypothetical? I can’t answer that question.

Winnie Wu

Fine, okay. Second question is regarding the Hong Kong mortgage market. With the recent spike in HIBOR, have you seen the mortgage loans priced at HIBOR-plus seeking the conversion to Prime-minus? I don’t know how common such cases were. If HIBOR stays at largely at a slightly elevated level, what would be the sum of considerations for you to start to change your prime rates?

Iain Mackay

Kathleen, do you want to comment on that? Clearly from our perspective we switch customers to the rate that is beneficial from the customer-borrowing perspective, and that’s how the mortgage is broadly constructed within the HSBC offering, but, Kathleen, do you want to provide any more detail?

Kathleen Gan

Yes, the Prime-related mortgages are priced at Prime minus 2.85%. So, our mortgages automatically switch from HIBOR-linked to a Prime basis whenever it is beneficial for our customers and vice versa.

Winnie Wu

Has that happened in a significant scale in recent months?

Kathleen Gan

No, not significantly. And it also depends on when the person signed up for the mortgage and at what rate they signed up for.

Winnie Wu

And what would be the sum of considerations for you to consider changing the Prime rate?

Iain Mackay

How rates develop.

Kathleen Gan

Yeah, as rates develop, whenever we deem – based on different macro factors and other rates or gaps between HIBOR and LIBOR, but we can’t sort of project or tell you what that’s going to be at this moment.

James Invine, Société Générale

Hi, good morning, just a couple more on the investment, please. The first question is, why do you benchmark it to revenues? Is that because the revenue environment gives you the resources to invest or because it’s a better revenue environment that makes the projects become viable. So, I’m wondering why you don’t benchmark it versus returns prior to investment rather than just revenue.

And then kind of more broadly on investment, can you give us a bit of help on the revenue payback period? So, what is the spread between, I guess, say, between one and five years?
Iain Mackay

So, a little bit of differentiation here. The investments are not evaluated against jaws; the investment are evaluated against what they do in terms of the overall operating efficiency of the firm and a return on tangible equity outlook. The envelope within which we evaluate the affordability of projects in the round in any given year is informed by revenue. That’s what informs the size of the investment envelope in any given year – the objective of generating positive jaws.

Within that envelope, individual projects are assessed against, first of all, are they mandatory? So, do we have to undertake that project such that we meet fully any of the obligations with respect to prudential regulation and conduct regulation in the round? That covers a whole range of topics. And then to the extent that it goes beyond meeting mandatory requirements, but about... How we can support cost productivity within ‘run-the-bank’, product innovation for customers or whether it’s from a technology perspective or whether it’s from a new-product introduction standpoint are evaluated against the hurdle rates that we’ve set for return on tangible equity for each of the products and businesses within the Group.

We have a strong preference that projects will pay back within a year, but, as you can imagine, in some of the longer, larger and more complex – particularly technology projects – the payback period is not always a year. It is sometimes 2-3 years from a payback perspective. The longer that payback goes into the future, the more robust the business case, if you like, has to be made by the project sponsor. Generally, those larger projects are sponsored by the heads of business, whether it’s Samir, Noel, Charlie or Peter and their teams. But that’s how we manage that.

James Invine

When you’re reporting, I guess, 2019 full-year numbers, will you be able to kind of say, ‘Here’s the investment that went in in 2018 and here’s the extra revenues that we generated from those investments.

Iain Mackay

In certain cases, yes. So, where the projects are related to specific revenue-generating activities, yes. Where they relate to mandatory projects for reg reporting, sadly not. Where they relate to, frankly, protecting the franchise and reinforcing the franchise, in some cases possibly not.

So, an example of that might be the mobile banking apps and PayMe that we’ve introduced over the course of the last 12-15 months in Hong Kong. That was as much about protecting the depositor base and the customer base in Hong Kong by offering them a functionality that a competitor was offering and eliminating that competitive threat – and reinforcing the franchise from that regard without necessarily adding specifically revenues to the Hong Kong P&L, for example.

So, in some instances absolutely we will be; in others it would be impossible, certainly where they’re related to mandatory programmes – and possibly more effort than it was worth when it was related to projects focused on protecting and reinforcing the franchise.

David Lock, Deutsche Bank

I’ve got two, please. Firstly, I noticed there was a methodology change for GB&M. Could you confirm that? There was an RWA reduction in GB&M in the quarter. Is that all of the risk-weighted model changes for this year or are there more to come?

Iain Mackay

No, it’s not yet. We’re still working on a few.

David Lock

Okay, so that should land over the rest of this year.
Iain Mackay
Yes. We’ve made good progress in terms of PRA model-approvals over the last month or two. We still have a few which are subject to approval and we would be hopeful that we would see a few more roll their way through as the year progresses.

David Lock
Okay. And the second one is just on the cost investment on ‘change-the-bank’. It’s more just asking, really, for a bit of colour on the quarterly progression. Because, as it strikes me, Q2 is going to be a tough jaws performance again, because you’ve –

Iain Mackay
It’ll be negative. I can tell you that now. It’ll be negative.

David Lock
But Q3 and Q4, could you give us an idea of the quantum of the investment spend compared with Q1? I appreciate some of this is lumpy, but it would just really help us understand the…

Iain Mackay
Not really, because it will be informed by how we see the overall revenue environment develop. So, going back to John’s comment, our focus is on generating positive jaws for the full year. If the revenue environment remains as constructive as we see it presently, then we’ve got a – and we talked about this on Friday – cost profile that would be broadly consistent with what we saw in the first quarter.

To the extent that we see a revenue environment that is less constructive, then we would do some re-phasing or some reprioritisation of projects to tie that off.

David Lock
So, just thinking historically, the ‘change-the-bank’ spend you’ve made in Q1 – how does that compare to Q3 and Q4?

Iain Mackay
So, compared to Q3 and Q4, we’re a couple of hundred million dollars higher in the first quarter of 2018.

David Lock
Okay, thank you.

Tom Rayner, Exane BNP Paribas
Can we just come back to the question I asked on the call the other day? Maybe can you help us interpret your Q1 provision number a little bit more? Obviously you had a very detailed transition document on IFRS 9 out there, which I guess everybody has read. Consensus is or was before the results $2.6 billion for this year and it’s $170 million. I’m trying to get to head around how we should even think about impairments in this current environment.

Iain Mackay
Great question, Tom – I’m trying to get my head around it as well.

Look, the performance of our portfolio… So, when we look at… If you looked at it from a wholesale-lending perspective, we look at it from a Watch/ Worry / Monitor list standpoint, which are really all those credits that we’ve seen ratings downgrades on – and by that I mean our internal ratings downgrades on. The contents of those lists remains fairly consistent, which is indicative of a reasonably stable credit performance across our major portfolios.
When you look at the retail books of business, again in those businesses where we’re growing – and particularly growing unsecured credit, Mexico being first amongst those, the UK and Hong Kong to a slightly lesser degree – we are seeing the level sort of impairments or Expected Credit Losses coming through that we would expect.

In the first quarter – and this will be the case every quarter – one of the requirements within IFRS 9 is to examine forward economic guidance, and that forward economic guidance then informs modelling that then obviously informs what we would expect to see in terms of transition from stage 1 to stage 2 and less so in terms of transition from stage 2 to stage 3. What we saw in the first quarter is probably not surprising to any of you based on the performance we see across Asia, across the United States, across many of the jurisdictions in which we’re operating, is an improving forward-looking economic outlook, and therefore it informed forward-looking economic guidance in our models that saw some of the impact on Expected Credit Losses lower or non-existent or in actual fact credits in the first quarter than we saw at the introductory stage on 1 January 2018.

So, I think to boil it down – and Gavin, please add in anything on this one that you think I’ve missed or we can amplify – we’ve got quite a lot of learning to do over the coming quarters in terms of the different components. We know mechanically what influences model outcomes, but I think we’ve got quite a lot of learning to do in terms of understanding what we see with a historical mindset, looking at it from an incurred-loss perspective and translating that into meaningful insights around an Expected Credit Loss approach coming out under IFRS 9.

So, I first of all have a degree of both appreciation but also empathy with you that this is not an easy one to see through at this point in time, and we will absolutely build experience and to the extent that we can improve the quality of the insights we will do so.

Gavin, anything to add?

Gavin Francis, Group Chief Accounting Officer

So, on the forward economic guidance, it can work both ways, so Iain’s right that overall actually Q1, from a forward-economic viewpoint, was slightly better than where we were at year end, from a sort of GDP perspective, but of course GDP is not necessarily the thing that feeds the risk models. So, for example, in Q1, in the unsecured retail space, one of the drivers behind the number you saw is actually some moves to stage 2 because of forward economic guidance, nothing else. So, that obviously then drives a measurement change.

Conversely, on the wholesale side, actually what you saw was some names flipping from stage 2 into stage 1 – once again, forward economic guidance and the drivers within the actual economic response models themselves. And we’re going to see that every quarter. And I think clearly we’ve got a lot to learn, but part of it will be looking through some of that quarterly noise that we basically will get.

I think, for me, when I look across Q1, you know, just taking away some of that forward economic guidance noise which goes both ways, frankly not much to see from an ECL-content perspective. Actually, because that ECL content or variance is so low, what you then have are things like write-offs and recoveries actually having a somewhat disproportionate impact both on the balance-sheet stock but also the P&L number as well. To echo what Iain said on the call, really not much to see in Q1 from an IFRS 9 from an ECL viewpoint.

Iain Mackay

Okay, any other questions?

Claire Kane

Just to follow up on the $897 million provision, will you be disclosing the settlement of that HSBC Finance…?

Iain Mackay

When we settle them, yeah.
Claire Kane
I thought you’d reached a settlement.

Iain Mackay
There may be disclosure at the half year.

Claire
And then we just back out the differences for the DoJ one.

Iain Mackay
Yes, deduction would work.

Raul Sinha
Can we have a split of the charge between the ongoing rate versus the recoveries or is that not possible under IFRS 9 at all?

Iain Mackay
There’s transition, really: stage 1, stage 2, stage 3. And reversal: stage 3, stage 2, stage 1, which would give you the movements. I’m not sure we can…

Gavin Francis
IFRS 9 is a journey both in terms of learning and in terms of… How long do you want me to talk about this?

Iain Mackay
Right, chaps, it was fun. I’ll leave you to it for the rest of the morning with Gavin.

Gavin Francis
IFRS 9 is definitely a journey, as I say – Iain likes that word – but also from a disclosure set viewpoint. So, I think, as we roll through this year, we will look to progressively roll out our disclosure set around IFRS 9. We did a fairly fulsome transition documents. A bit of the noise you see in some of the Q1 disclosures, quite frankly, is getting some of the data right. It doesn’t impact… The overall impact is not material, but at a granular level there is some of getting the data right. As we roll forward, at H1 you will see a greater disclosure set and obviously you’re seeing it at Q1 and once again at year end.

I know you’re asking for recovery data; we’ll obviously look at that. It clearly is a component of the P&L charge. Nothing has changed from IAS 9 in terms of treatment of recoveries, by the way. It’s always been in there. I guess the point I made before… It’s just because the ECL variance content is so low it sort of figures a bit more highly than would have been the case before, but, once again, looking at the recovery trends, there’s nothing that’s out of the ordinary, frankly, from what we’ve seen there before.

Iain Mackay
Nothing at all. Any last questions? Okay, well, as ever, thank you very much for your time this morning. We’ll look forward to speaking at the half year.
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This presentation and subsequent discussion may contain certain forward looking statements with respect to the financial condition, results of operations and business of the Group. These forward-looking statements represent the Group’s expectations or beliefs concerning future events and involve known and unknown risks and uncertainty that could cause actual results, performance or events to differ materially from those expressed or implied in such statements. Additional detailed information concerning important factors that could cause actual results to differ materially is available in the HSBC Holdings plc Annual Report and Accounts 2017. Past performance cannot be relied on as a guide to future performance.