Transcript

Fixed Income Interim Results

Conference Call with Analysts and Investors hosted by Iain Mackay, Group Finance Director

6 August 2018, 2.00pm BST

Corporate participants: Iain Mackay, Group Finance Director

Iain MacKinnon, Group Treasurer

HSBC

Iain Mackay, Group Finance Director

Good afternoon from London. Good evening to those in Hong Kong, and good morning to everyone in North America. Welcome to our 2018 interim results call for the fixed income community. With me today are a number of colleagues from our Treasury and IR team, including Ian MacKinnon, our Group Treasurer. I expect most of you have already had the chance to listen to this morning's call, where we ran through the results in detail. I'll run over the key points briefly and then open up the call to questions and answers.

In June we set out eight strategic priorities that will enable us to grow our profits on a consistent basis and create value for shareholders. In particular, we aim to deliver a return on tangible equity of more than 11% by the end of 2020. To do this, we intend to deliver growth from areas of strength, to turn around low performing businesses, to invest in revenue growth and the future of the business, and to simplify the organisation and invest in future skills. Central to this is our ability to use the revenue capacity of the Group to invest in growth and competitiveness within a constraint of full-year positive jaws.

For the first half of the year, reported profit before tax was up 5% compared with the same period last year and adjusted profit before tax was down 2% due to increased investment in the business. For the second quarter, reported profit before tax was up 13% and adjusted profits were broadly in line with last year's second quarter. This performance was in line with our expectations. Our global businesses delivered an increase in adjusted revenue of 7% in the second quarter. This was offset by the corporate centre, which was down against a strong second quarter in 2017. In line with the guidance we issued in May, our second-quarter adjusted costs rose by 7% and were stable compared with the first quarter. We grew lending by a further 3% compared with the first quarter and 5% from the start of the year. Our common equity tier 1 ratio remains strong at 14.2%. This includes the impact of foreign currency movements and the full amount of the $2 billion share buyback that we announced in May.

Liquidity and funding remain strong, with $540 billion of high-quality liquid assets on hand. Our liquidity coverage ratio stands at 158%, while loans and advances are equal to just 72% of our $1.4 trillion deposit base. We are well on track to meet our end-point MREL requirements ahead of time. This year to date, we have issued over $10 billion of MREL-eligible senior debt, bringing the total outstanding to $53 billion. We reiterate this year's $12 billion to $17 billion issuance plan for MREL-eligible senior debt, likely landing at the top end of this range. Additionally, we may look to pre-fund part of our 2019 issuance if we judge market conditions to be accommodative.

Alongside MREL, we've issued over $4 billion of AT1 in the first half. Our year-to-date issuance brings us near to our $5 billion to $7 billion issuance target for 2018. We continue to expect our AT1 issuance to land around the middle of this range, albeit subject to market conditions. With our $2 billion equity buyback ongoing, we've been precluded from issuing AT1 since early May. As of Friday's close, the programme was 89% complete. Looking out to next year and beyond, we anticipate our AT1 issuance levels will fall towards simply meeting refinancing needs and funding RWA growth. In tier 2, we have no plans to issue this year given our healthy excess in this area. Our operating subsidiaries will continue to issue a small amount of senior unsecured debt to fund growth.

To conclude, HSBC has a strong credit story. Our global businesses have now delivered eight successive quarters of year-on-year revenue growth and carry momentum into the second half of this year. On this basis, we remain confident of achieving positive jaws for the full year. Our main focus is on delivering a return on tangible equity greater than 11% by 2020. We are a well-funded business with strong capital generation and a diversified balance sheet, and we are investing to grow revenue further and strengthen our competitive position. We remain cautiously optimistic about economic conditions for the remainder of 2018. We will now take questions, and the operator will explain the procedure and introduce the first question.

Robert Smalley, UBS

Good morning from New York. Thanks for doing this call in US hours – greatly appreciated. Greatly appreciate the deck as well. Three real areas of interest, if I could. First, on the net interest margin, I know you were asked this earlier on the call – I really wasn't sure about the answer, though. Could you talk about your European NIM and why it's at the level it's at? What do you think the kind of go-forward level is, given ring-fencing the Bank, liquidity needs, etc? That's the first one. The second is, in terms of issuance, could you talk

about currency distribution? I know in the past you've wanted to reflect your asset composition. Third, I want to ask you about US acquisitions.

Iain Mackay

Okay, thanks, Robert.

Robert Smalley

Thank you.

Iain Mackay

Net interest margin… So the Group overall – the themes are consistent with previous quarters. We continue to see progress in net interest income informed by policy movements, particularly within US dollars and currencies directly linked to the US dollar. That most notably informs progress in terms of net interest margin in Asia-Pacific, where we have a very strong funding surplus, and the propensity to invest that and deploy that funding surplus to generate net interest income, in addition to which we are beginning to see in Asia a stabilisation of some of the asset pricing pressures we've experienced over recent past quarters. So the performance in Asia in this regard remains the key theme in terms of net interest income and net interest margin development for the Group.

In the first half of 2018, and specifically the second quarter, we focused on ensuring we met certain regulatory ratios that were developed for HSBC in approaching ring-fencing, and specifically the liquidity coverage ratio, our net stable funding ratio, for the non ring-fenced banks, so the derivative of the ringfenced bank. So, just to clarify, our UK bank, which was HSBC Bank plc, to meet the requirements of the Banking Reform Act of 2013, was required to ring-fence certain activities. Those activities to be ringfenced, broadly speaking, were Retail Bank and Wealth Management, a substantial portion of the Commercial Banking business and the Private Banking business. That which sits outside the ring-fenced bank is, broadly speaking, Global Banking and Markets and certain other activities which are prohibited by law from being included inside the ring-fenced bank.

The ring-fenced bank started trading on 1 July of this year under the name of HSBC Bank UK plc. The non ring-fenced bank is HBEU or HSBC Bank plc, as it is known and has been known in the market for quite some time. The funding of the combined HSBC Bank plc pre ring-fencing was made up of a broad diversification of customer deposits within Retail Banking, Commercial Banking, Global Banking and Markets wholesale funding. And, on ring-fencing, the vast majority, as you could reasonably imagine, of deposits within the Retail Banking and Wealth Management, and Commercial Banking and Private Banking businesses went to the ring-fenced bank.

The liquidity and funding value, from a regulatory perspective, of the deposits and funding that remained within the non ring-fenced bank, so HSBC Bank plc, fell slightly short of where the regulatory requirements were set for that organisation to be effective 1 July 2018. And in the first half – and specifically within the second quarter – we took actions to raise appropriate funding from diversified sources, including deposits, CDs and other forms of wholesale funding to ensure we met and exceeded the LCR ratio requirement and the NSFR requirement at 1 July. We've done that, and we will spend the second half of 2018 and beyond fine-tuning the balance sheet as the activities within the non ring-fenced bank continue. Raising that funding and liquidity requirement increased our cost of funds specifically within that legal entity during the first quarter, and that was the most significant headwind in terms of informing what otherwise would have been fairly steady progress in terms of net interest margin for the Group as a whole. So that's a little bit of amplification around what specifically we disclosed on page 13 within the equity investor deck that we published this morning.

In terms… I'll go to your last question next, because it's a fairly easy one. US acquisitions – it is unlikely that there'll be any significant US acquisitions in the foreseeable future. We certainly won't discount the opportunity to consider digestible bolt-on acquisitions, possibly focused within the Wealth Management space more generally, but there is nothing specific at this point that we could refer to – and therefore it is very much a focus on building the business in the US organically. The team in the US has clearly made a lot of progress in terms of meeting the regulatory requirements of various regulators in the United States. And in terms of growing revenues, managing costs and improving capital efficiency, the business has made very significant progress

over the last couple of years. There is clearly more to do until the US achieves a level of return against equity invested in that business which would be appropriate and acceptable to HSBC as a whole, but significant progress continues to be realised. But significant acquisitions at this point in time are not a significant part of the focus.

In terms of –

Robert Smalley

Hello.

Iain Mackay

Yes, sorry, go ahead.

Robert Smalley

Sorry about that. So in the press in the past Synchrony Financial had been mentioned as a possible target. Basically, that's – what you're saying is that's a little too big and a little bit over the horizon if at all at this point.

Iain Mackay

Yeah, there was never substance to that whatsoever. We're still somewhat mystified as to where that media coverage came from, but that was never on the cards.

Robert Smalley

Me too, so thanks.

Iain Mackay

No pun intended. With respect to issuance… Sorry, refresh me on the question on issuance.

Robert Smalley

Just in terms of currency –

Iain Mackay

And buybacks, yeah. Yeah, sorry. So, look, our intentions remain consistent. Our intentions for the future remain consistent with our actions in the past in terms of broadly trying to match the currency of issuance in the market with the competition of the balance sheet and the funding required on the balance sheet. So we will – we have further diversified and we'll continue to focus on diversifying issuance to align to the composition of the asset side of our balance sheet, so although we continue to issue the majority of our paper in dollars, that is informed by the fact that we have a very significant US dollar business in various locations around the world, and even where instruments are issued out of the holding company in dollars, that tends to be downstreamed to our operating subsidiaries which have US dollar exposures which require funding.

Robert Smalley

If I could just follow up, there's no need to kind of compensate or kind of lean in one direction or another in order to reflect this – this is kind of a go-forward policy, so there's no need to do, say, more dollars than you had in the past or more euros than you had in the past to balance out the portfolio.

Iain Mackay

No.

Robert Smalley

And you had mentioned being at the top end of the range for issuance and potentially pulling forward some, but your redemptions next year are a lot less. So, if that's the case, would we expect a lot less issuance in 2019?

Iain Mackay

I think our issuance going forward will be informed by the regulatory requirements, most notably with respect to MREL in the round. And clearly that's an area where guidance from various regulators around the world continues to develop. And also informed by the level of refinancing, so redemptions that would be coming through the pipeline. So, broadly speaking, our guidance with respect to the overall level of issuance of MREL remains broadly consistent with where we've guided you in the past, and I think the factors that would inform any change to that guidance will be informed by how regulation in the round, but specifically with respect to MREL/TLAC requirements shapes up over the coming – I won't say months, because I suspect it will be quarters or even years.

Robert Smalley

That's great, thank you. And thank you for all the fixed income disclosure – it's greatly appreciated.

Iain Mackay

You're very welcome. Thank you, Robert. Next question.

Lee Street, Citigroup

Hello, good afternoon all. Three questions from me, please. Just firstly on the Bank of England paper on MREL in June, what are your thoughts on how it impacts your operating company issues, subordinated debt and whether you take it as a confirmation that for any OpCo sub debt that you've got outstanding which is under a UK law, that that does not represent an impediment to resolution.

Secondly, in the slide deck, you noted you're currently evaluating the HKMA proposals on MREL – just any thoughts you could give on the impact on the Group might be. And, finally, just a simple one – any more colour you can give us on the potential funding needs for HSBC Bank plc, please.

Iain Mackay

So, HSBC Bank plc – I think we entered into 1 July both with an NSFR and an LCR somewhat above where the requirement, we believe, will be in the long term, so there's a bit of fine-tuning and balance sheet optimisation to be done in the second half of the year and beyond. I would not expect funding requirements to go above those that were disclosed at 1 July, so I would be inclined to be guided by that or even a slightly lower level of funding and liquidity, because we did very purposely go into the formation of the Bank with what we thought was a fairly prudent, conservative position with respect to that.

In terms of the Bank of England paper on internal MREL, helpful, right – movement in the right direction in terms of providing guidance, but I think there are still aspects of that guidance which are to be grounded out, on which there is an active dialogue from the industry with the Bank of England and the Prudential Regulation Authority. So helpful – in fact, I won't say I'm not sure it changes – at this point in time, we do not believe it necessarily changes our overall view with respect to how recovery and resolution, or specifically resolution, would work and specifically the eligibility of any of the capital or debt instruments that we've got in place at this point in time.

So more work to be done, and I think exactly the same would be said of the HKMA consultation in that regard. What is encouraging is that the guidance is now in front of us. There is an opportunity to consult and engage with our principal regulators around that guidance, and there is clearly, you know, a very strong focus on the part of those regulators to gain industry feedback from the industry and fine-tune the guidance as we go forward. So I think the overarching comment that the team would make back here is that it hasn't changed in any significant way our interpretation or attitude towards funding requirements in the context of recovery and resolution at this point in time.

So I think – what is clearly, at a European, there's both CRR2 and what we call CRD V, if in fact such a thing ever becomes real, but clearly where we stand today is that we've got eligibility for instruments informed by CRR and CRD IV. To the extent that any of the requirements change between mark one and mark two of CRR and CRD IV and CRD V, then that would clearly inform any changes we may need to make in terms of the

overall eligibility of capital and debt instruments that sit within the structure today. But I think, again, that's developing space which we are engaged in. But today our focus is on optimising the eligibility of our capital instruments within the guidance offered by CRR and CRD IV.

Lee Street

Okay, that's clear. Thank you for your comments.

Iain Mackay

Thank you.

Corinne Cunningham, Autonomous Research

Thank you. Afternoon, everyone. My questions have been mainly asked, but I've got a couple of follow-ups to Lee's, really. The first one, in terms of… When do you think you might get clarity on the role of some of your legacy bonds in resolution planning and requirements? Is it something you already have or…? You mentioned the dialogue is being ground out. Any guidance as to when you think that might be clarified would be helpful.

The other one is perhaps more a little bit of head-scratching, really, about multiple versus single point of entry for the Group. So, you've gone down a multiple point of entry route, but so far all of the MREL has been issued from the Group, and it sounds like that's your intention to carry on doing it that way. Have you chosen to go down the multiple point of entry route because it actually lowers your overall requirements? So, if you were a single point of entry you would have to have higher requirements overall. Is that basically the driving feature for why you're multiple rather than single point of entry?

Iain Mackay

Yeah, it's a great question. So, on your first, guidance, no, we don't have it. So there is – we've got policy papers out there from a number of our regulators. We're engaged in conversation with them, but there is no final guidance. And as for when we expect to receive it, I'm afraid my crystal-ball gazing capabilities don't extend that far, but I expect it's sometime in the future.

As far as multiple point of entry goes, so I suppose I could embark on a regulatory rant at this point, but I'll spare you all of that. Look, our corporate structure, where we operate as a holding company with a number of key operating subsidiaries, which are funded and capitalised to be resilient in periods of stress without the need to resort to assistance from the holding company, has been our capital management and funding practice and risk-management framework, for many, many years. The Group naturally – that structure naturally lends itself to multiple points of entry resolution. Our principal resolution hubs, as recognised by the PRA and our principal regulators, so the HKMA, the Federal Reserve in the United States, is… Underneath HSBC Holdings plc, we have a European resolution hub, which up until recently the principal subsidiary within that was HSBC Bank plc. Our Asian resolution hub is the principal operating company, the Hongkong and Shanghai Banking Corporation. And then, thirdly, our US resolution hub, the principal operating entity of which is the HSBC Bank, but the holding company of which is HSBC North America Holdings.

And the purpose of issuing our resolution instruments out of the holding company – those instruments are issued out of the HoldCo, one, because we have a strong track record with all of the processes and capabilities in place, to issue a diverse range of instruments from that holding company and then downstream them to the main resolution hubs in a form that is identical to that to which we issue to the marketplace. So there is literally a back-to-back transaction where anything that is issued from the holding company – the significant majority of it is downstreamed to those resolution entities.

On event of resolution, what would then conceivably occur? So, this is the principle behind multiple point of entry. Those bail-in-able instruments would then be bailed-in by the local supervisor, the local regulator, and the local entities would be re-capitalised, the operating entities would be re-capitalised upon the bail-in of those instruments held at the local holding company level. And in so doing the losses would be upstreamed to the ultimate holding company, HSBC Holdings plc. And in so doing, what we would do is we would retain the integrity of the corporate structure of the Group, thereby enabling local regulators, whether in Hong Kong, the

United States or Europe, for example, the time and capacity to go ahead and execute an orderly resolution of operating subsidiaries and activities within HSBC.

So that is the point behind multiple points of entry. In terms of… Does it give us any particular advantage or saving in the context of MREL, for example? As much as we would like to think it does and should, it doesn't. So… At least there's no evidence of that at this point. So the guidance at the moment around what our requirement will be is the higher of the sum of the parts requirement, i.e. the guidance provided for local regulators responsible for the resolution within that community. And what is it? 18% at the end state and I think 16% between now and… 18% of RWAs or 6.75% of leverage exposures. So our… We at the moment are aiming for that 18% of RWAs. When guidance from our local regulators responsible for resolution in those jurisdictions provide us with settled regulation as to their requirements, it will determine whether that 18% of RWAs at a Group consolidated level or the sum of the parts is the binding constraint or the target, if you like, from an MREL standpoint.

But, again, that goes back to your first point, Corinne, which is at what point we get guidance around exactly what is required of us from a resolution perspective and, consequently, MREL requirements. So it is overall a little bit of a moving feast, but at the risk… Well, not putting words in my mouth, but the regulators, certainly our UK regulator and our principal regulator, the Prudential Regulation Authority, look at that approach to resolution as being robust, workable – but we clearly need more guidance in terms of where regulation ends before we can button that down.

Corinne Cunningham

Okay, thanks very much.

Iain Mackay

Thank you.

Corinne Cunningham

Thank you.

James Hyde, PGIM

Hi. I've got three questions, please. First of all, I just wanted to get a better understanding of the profile of the Group going into Brexit, in terms of earnings. You've taken away some disclosure on UK, but you've helpfully included this HoldCo impact. Would it be fair, am I right in thinking that annually UK, without HoldCo, is about $4 billion pre-tax? It seems a bit high to me, but I just want to check out of the $21-22 billion underlying. That would be the first question.

Secondly, on the impact on the UK or impact on European earnings, what is your feeling about being able to keep the European subsidiaries and branches under what is still HBEU/HSBC Bank plc, or does it have to go straight to the HoldCo with a new intermediate European/mainland Europe/Eurozone HoldCo? What would be the impact of that should it be necessary?

Thirdly, I just want to know if there's any more sense of the impact of BEAT, of the base erosion anti-tax avoidance, and whether it does necessitate some US HoldCo issuance for optimal tax management. That's it.

Iain Mackay

Okay, thank you. James, I'll take those in reverse order. On BEAT, all the work that we've done up to this point would suggest that we will not be subject to BEAT. Therefore, we'll keep a very close eye on that, because final regulation around the implementation of the tax reform bill in the US in December of last year, but all of the work that we've done and advice we've taken would strongly indicate that we will not be subject to BEAT in the US.

On the HBEU, well let's not… HBEU – it's HSBC Bank plc. Let's talk about the structure going into Brexit. We have always approached Brexit with the view that we ought to prepare for the worst-case scenario, so

euphemistically a hard Brexit, and hope for a better outcome. The contingency planning and, in effect, implementation that we are effecting is informed by what we would believe is a hard Brexit. In that vein, we are perhaps fortunate, you might say, to have a significant operating bank with a universal banking model in France that was the product of our CCF acquisition a number of years ago. That bank today carries on Retail Bank and Wealth Management, Commercial Banking, Global Banking and Markets, and Private Banking activities, and has a broad product and service capability very similar – obviously to a smaller scale – but very similar to that of HSBC Bank plc.

Some of the actions that we have done to effect an operating capability to meet our customer requirements upon Brexit, whatever form that may be, is to ensure that the product and service capability of the French bank exactly mirrors that of the UK bank, so we have been working on and are largely complete in terms of ensuring that product and service capability is in place, in terms of systems, processes, risk management and functional support. We have not, at this point, started moving any significant numbers of employees into that French legal entity, by virtue of the fact that we continue to support most of our customers that are banking across the European market, substantially through the UK bank.

What we have also done is applied to the ECB and to the PRA seeking approval, and such approval has been obtained, to take the branches of HSBC Bank plc that operated across Europe – we were operating in some 20 countries across Europe – through a branch structure supporting corporate banking activity. Those branches have been part of HSBC Bank plc. Those branches are now being repointed to become branches of HSBC France. HSBC France will be the principal operating subsidiary of the Group supporting our customer activity across the continent. We have two other subsidiaries in continental Europe. One is Trinkaus & Burkhardt in Germany, where we own 80%, and the other is Malta, where we own just under 100% of that bank. All three of those entities are subject to SSM regime.

Post Brexit or as we approach Brexit, in whatever form it takes, our French entity will have the capability to support our customers in whatever activity they undertake across the European Union. The activities outside France, Germany and Malta will be conducted through branches of the French bank, HSBC France SA, and the UK activities will be made up of the ring-fenced bank and the non ring-fenced bank. They will continue to cater to international customers, but obviously not those that are required to be supported by a European duly formed and regulated institution.

In terms of the holding structure there, today, HSBC France is owned by HSBC Bank plc. The holding structure will be changed such that two UK entities will be held by an intermediate holding company in the UK and our European entities will be, we believe, subject to an intermediate holding company, the regulation of which still has to be formed. When that European holding company is formed, the French, German and Maltese subsidiaries will be subsidiaries to that holding company. That holding company will then either become a sister entity to the UK holding company or will be held within that UK holding company, but we await guidance and the final form of regulation before any decision in that particular holding structure is taken.

Your last point was around UK earnings. The UK bank, on a PBT basis, through the first half of this year – well, if you think about a normalised run rate for earnings of the UK bank, it tends to be between $2.5 billion and $3 billion per annum on a profit-before-tax basis, as adjusted. In terms of the first half of this year, there were some significant reductions in revenue through the Corporate Centre within the UK, and also we had somewhat lower revenues within the Global Markets business orientated out of the UK, which informed a lower-than-usual adjusted profit before tax in the UK. In the UK, broadly speaking, the run rate of adjusted earnings tends to sit somewhere between $2.5 billion to $3 billion. That encapsulates both the ring-fenced and the non ring-fenced bank.

James Hyde

Is that ex the HoldCo or with the HoldCo?

Iain Mackay

That's ex the HoldCo.

James Hyde

Okay, so my figures are a bit wrong then. Okay, thank you very much.

Iain Mackay

Thank you very much for joining us today. As ever, your time was gratefully appreciated and I know that, if you have any follow-up questions, you'll follow up with our Investor Relations team. Thank you for joining.

Forward-looking statements
This presentation and subsequent discussion may contain certain forward-looking statements with respect to the financial condition, results of operations, capital position 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 our Interim Report. Past performance cannot be relied on as a guide to future performance. This presentation contains non-GAAP financial information. Reconciliation of non-GAAP financial measurements to the most directly comparable measures under GAAP are provided in the 'reconciliations of non-GAAP financial measures' supplement available at www.hsbc.com.

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