Transcript

Full-Year Results 2017, Equity Analyst meeting

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

26 February 2018, 10.00am GMT

Corporate participants:

Iain Mackay, Group Finance Director

Kathleen Gan, Chief Financial Officer, Asia Pacific

Richard O'Connor, Global Head of Investor Relations

Gavin Francis, Group Chief Accounting Officer

HSBC

Iain Mackay, Group Finance Director

First question, Alastair.

Alastair Ryan, Bank of America

Could you walk us through the moving parts, please, of your net interest income? I think we failed to come to a good sense on the call last week of where you feel it's moving at present, driven by volume growth and margin trajectories. So the margin ticked up in the fourth quarter, the loan growth ticked up in the fourth quarter. The deposit growth was strong. Currencies have gone your way. It feels like there's quite a number of issues – a number of things – that should be pushing that up this year, can you give us a sense of where that is in your view at present? Thank you.

Iain Mackay

The net interest income sensitivity analysis that we provide you sets outs the assumptions on which we've calculated that, right? So, we have not factored in the Fed adding another three or four quarter point rises over the course of 2018, which I think we probably all believe is a possibility. So, we've hopefully set out fairly clearly for you what the assumptions are in terms of net interest income and development without factoring those elements in, based on a year-end balance sheet. Clearly, what we've demonstrated over the course of 2017 is mid-single digit growth, both in terms of net interest income but also from a balance sheet perspective, and our expectation is that we've got reasonable momentum in our main markets, in terms of growing the balance sheet and growing the income from that.

We clearly have some pressures coming through to counter that growth – as we work through this rate cycle, we have always seen, and continue to expect to see, some pressure coming through BSM revenues. That's probably in the range of $200 million to $300 million on the year, so if you think about BSM guidance, historically it's been between $2.5 to $2.7, $2.8 billion. It's probably more realistically in the $2.2 to $2.5 billion range for 2018, based on what we know at the moment. Our balance sheet growth continues to be mid-single digit. I think somebody managed to coerce out of me 7% last week. That's still mid-single digit, but realistically, I think we – when you take all the markets in the round, Asia's obviously been going reasonably hot, where we continue to focus more of our capital, and the UK and other markets tend to be a little bit slower. So, I still think mid-single digits, but probably erring – from a prudence perspective, more like 5% is probably the right sort of range.

So candidly, I think we've given you the building blocks of what we think – of how net interest income develops over the course of the coming year, based on balance sheet dynamics; based on how we've modelled out the scenarios that we've set for you. We have not factored in anything from a rate perspective beyond that that the forward curves presently indicate, and therefore, to the extent that we get any upside from the US dollar or, for that matter, the Bank of England – I don't think we really expect anything more from the Bank of England than that which we've already received in November -- but to the extent the Fed moves further ahead, then we would clearly expect to see some of that feed through to the net interest income equation for us, largely through the liability spread side.

We've set out for you in the basis of preparation around net interest income sensitivity what we consider from a deposit beta perspective, and then you have to factor in what happens from HIBOR. What are the pressures that we see against that? I mentioned BSM. The other is another couple of hundred million as we continue to meet our MREL and other regulatory requirements over the course of 2018, and then, as you saw in 2017, a little bit of pressure coming through asset spreads.

There is no indication that we're likely to find any relief in the immediate future. The net interest margin for the Group has been fairly consistent, and what has typified that is exactly the elements that we set out in the pages within the investor deck – so we've seen a bit of asset margin pressure coming through both corporate and mortgage lending in Asia and in the United Kingdom. We've obviously had a little bit of adverse impact on foreign exchange over the course of 2017. How that plays through, we'll see as the rates move, and then we've seen the benefit coming through liability margins. I can't give you more than that at this point in time.

Raul Sinha, JP Morgan

Iain, can I ask you to talk to us a little bit about the message on capital on core tier 1, because it felt like there was a shift there in terms of your commentary, and within that, if you could talk to us about the stack as it moves with the Hong Kong counter-cyclical buffer coming in – some of the various drivers that might not already be in your stack today, but are expected to come in? That would be useful. Thank you.

Iain Mackay

So, in terms of counter-cyclical buffer between the UK and Hong Kong today, that represents 60 basis points from 1 January 2018 of the common equity tier 1 total for the Group. What we tried to guide in the last week is that we – and what we guided all last year on, which is that we saw 13%, the top end of the 12% to 13% range, as being the appropriate place to have common equity tier 1. And what we were trying to get across last week was that we see a little bit of upward pressure to that, and it is informed largely by the fairly consistent behaviour that we've seen coming from the Prudential Regulation Authority over the last couple of years about how they use the stress test to inform what they do in ICG –Individual Capital Guidance for the firms - and how that then informs Pillar 2A and PRA buffers.

I think you all saw the published results at the end of last year from the Bank of England stress test, ACS. You saw that we started in a stronger position, but we also saw a deeper dip – a bigger dip – on a much more severe stress across the various markets which the stress tests addressed. And on that, it is our view that we're likely to see a little bit of upward pressure on the PRA buffer as a consequence of that. We won't get final guidance from that until the middle of the year from the PRA, but I do think that probably pushes up gently above the 13% range. Whether it takes us to 13.5% from a common equity tier 1 perspective will be informed by the guidance. I think if you speak to other UK bank CFOs, they are seeing the same.

And that is the dialogue that we are having with the Prudential Regulation Authority, about "We're a little bit confused, guys". 18 months ago, the Governor said, "Look, 12% to 13% is pretty much the right place. We think the sector is well-capitalised. If there is RWA inflation coming through from Basel IV, we would expect some relief in Pillar 2A, because that's what Pillar 2A is for. It's to address risks that aren't captured in Pillar 1 through the measurement system coming from BCBS." And I think the industry took – certainly we took some comfort from that. What we then saw was a little bit of a step up in the PRA buffer in 2017, and what we have some expectation about – but it needs to be informed by conversation with the PRA as they go through our ICAAP, which will be submitted at the end of this month, in combination with the results of the ACS, and find out whether that informs further upward pressure on the common equity tier 1 ratio. My own view is that we're probably nudging above the 13%. Whether it's 13.5% – whether it gets us all the way to 13.5% or higher, I don't know, but I suspect we're somewhere above 13% now.

Raul Sinha

Why is your timing different from the other banks? Lloyds has got its letter, and some of the other guys have got their PRA buffer letter, so –

Iain Mackay

I don't know if they've got a letter or not. We get our letter usually in the latter part of the second quarter.

Tom Rayner, Exane BNP Paribas

Can I just go back to the volume growth, please, Iain? I hear what you're saying on the 5%. If I look at your Q4 numbers, on a constant currency, ex the red ink, the helpful slide you give us on slide 31 – it does look like you're annualising at that pace in Q4: just over 5%, I think. And obviously very strong performance coming through in Asia, more like 13%, but obviously falling back in Europe. I'm just wondering: could you talk a little bit about the mix going forward? Maybe it looks exactly the same in '18 as it looked in the fourth quarter, or is there going to be some slowing in Asia, made up by a bit more from Europe? Obviously, UK mortgages is going strongly, so I'm just trying to get a feel for how you get your mid-single digit?

Iain Mackay

The pipeline, from a corporate perspective, is fairly robust. We saw that throughout 2017, notably from Asia. That being said, you also saw that we saw some large balance pay-downs in Asia in the fourth quarter, so overall, the pipeline across the Asian markets remains fairly robust at this point in time. Growth from a mortgage perspective is steady as it goes, recognising that, again, it is an area of particular focus from the HKMA's perspective, just to try to control overall risk in the mortgage lending market in Hong Kong. I think things are reasonably stable, and certainly if Kathleen has anything to add in her reflections in that regard, it would be helpful, I'm sure, to you.

From a UK perspective, the environment has remained fairly stable through 2017. We've been fairly clear about what we'd like to do in terms of growing our share in the market from mortgages. We see more of that share now through continued extension of the broker channel. I think we've now got 23, and that gives us a view of slightly over 60% of the market, and obviously we've got a fairly constant market share in terms of direct access through the branch network. So, we're seeing more of the kind of customers we would like to see. We've kept risk appetite very constant and consistent within the UK market, and on the back of that, we've been able to gradually grow market share, where I think on a stock basis, we're slightly over 7% from a stock perspective in the UK mortgage market now.

I think we've said, historically, we'd probably feel quite comfortable moving towards 10% in that regard, so a bit of work to do, certainly over the course of the next couple of years, to be able to possibly move in that direction. But it will also be informed by overall economic conditions in the UK, and I think it would be fair to say, you know, the geopolitics in terms of the UK, how we exit, Brexit – how that might inform not only corporates' attitude toward risk, but households' attitude toward risk, may well inform the overall rate at which we can grow that book in the UK.

Mexico continues to move forward nicely for us. A lot of the growth in that area, although reasonably balanced, is coming from unsecured personal credit. You obviously see slightly higher loan impairment charges coming with that, but I think across the NAFTA corridor, actually, the growth has been in the low single digits, and we would expect it to continue to be in that space. You look at the Middle East, it's pretty much steady as it goes. We've seen ups and downs in the Middle East; nothing of particular note. I think the area where there's uncertainty is whether Continental Europe can follow through on some of the more encouraging growth signals that we've seen over the course of the last six months, and translate that into better balanced growth for HSBC and the Continent. So, again, it's probably going to be largely informed by how Asia develops and how the UK develops, and from that standpoint, we see a reasonably robust pipeline in Asia and, at least for the moment, steady as it goes in the UK.

Tom Rayner

And related to that, I guess your margin comments –

Iain Mackay

So, if I were to boil that down, what do we think we see? Something not dissimilar to what we saw in 2017, with perhaps slightly more moderated rates of growth in Asia.

Tom Rayner

Okay, and I'm assuming the margin comments you've made already are consistent with the sort of mix profile?

Iain Mackay

Yes, that is correct.

Iain Mackay

Does anybody from Hong Kong have a question before we try again in London?

Gurpreet Singh Sahi, Goldman Sachs

Just a question regarding the Hong Kong and Shanghai Banking Corporation pay-out ratio. So, it is well-capitalised. I would say it has excess capital. Growth was good in '17; now you're saying that growth could be a bit more moderated in '18, but then the pay-out ratio last year was around 53%, and actually it was cut versus 2016. How should we think about the pay-out ratios going forward, and about growth? So, a mixture of the two.

Kathleen Gan

I think, first of all – I think our capital ratio is in line with the changes in the regulatory landscape, as well as targeted growth for the future, and some of the buffers are still phasing in, so I think you need to take that into consideration. In terms of pay-out ratios, I would assume that you can consider the same forecast that has been projected, above 50%, and that's what we are shooting for.

Manus Costello, Autonomous

I've got a couple of questions, please. Thank you for the new RoTE by global business disclosure. Why don't you allocate out the bank levy to the businesses, or indeed in any of your measures of RoTE? I'm just intrigued as to why you haven't got the levy in there. And how is this going to impact the way that you manage the business? Is this just for us, the RoTE stuff, or are you doing it internally? Is there going to be a change?

Iain Mackay

It isn't because that is – you know, we've used return on risk-weighted assets over the course of the last four or five years to improve our focus around the capital efficiency within the businesses, and for the Group overall. The RoTE is just to drill down into the wider capital equation by global business, by legal entity within the Group – so, again, if you think about the corporate structure of the Group, the liquidity management and capital management structure of the Group, it is, by virtue largely of how we're structured and how we're regulated, broadly speaking operating entity by operating entity. So, it is all very well to look at RWAs in the round, and we've done a – as you can see, we've done a good job of improving overall RWA efficiency over the course of the last few years by global business, and for the Group as a whole.

But when you get down to ensuring that each legal entity has the propensity – one, are all the legal entities working towards achieving a returns hurdle rate for the Group that is consistent with the overall Group hurdle rate, right? 10% or greater from a return on equity perspective. So, when you look across the Group – and Deutsche Bank did a piece of work whatever it was, a year ago, 18 months ago, which zeroed in on legal entities and where there were those performing better than others. Now, we all knew that the US wasn't great, France wasn't great, and there are other, smaller legal entities around the Group in which we needed to improve performance, and businesses – global businesses within those legal entities – that needed to improve performance: for example, Global Banking and Markets in Europe.

So the RoTE is an extension of going from, 'Let's focus in on RWAs by global business' to 'Let's focus on RWAs and tangible equity by legal entity, so that we know we're optimising capital – not only with respect to a PRA view of the world, but also with respect to local regulatory' – so that we ensure a) we're triangulating on the 10% or better return on equity for the Group, but that we can zero in on those legal entities where we've got a performance issue and ensure – whether that's driven by a differentiated application of regulatory capital – the US is probably the most outstanding example of that, in terms of differences to Basel III's application – and then accordingly, make sure that we're allocating capital in that legal entity such that we operate the balance sheet efficiently, create - through the way we price the product for the customer - surpluses that can be up-streamed to the parent company.

So, it is a consistent approach across the Group, on how we zero in on the efficiency of capital allocation by business, by legal entity, and that we get each business by legal entity focused on efficient deployment of capital.

Manus Costello

I guess what I'm driving at is, do you think it might encourage local management to manage their equity base, as well as managing the profits, and therefore potentially have some sort of impact on growth if people are focused on returns?

Iain Mackay

The input to virtually everything we do is capital, and if we don't have management teams focused on the efficient deployment of that capital, to customer relations and the products that generate returns for the Group, then the propensity for Hong Kong, the US, Mexico or any other subsidiary to upstream capital to the Group to support strategic flexibility – whether it's with respect to investing for the future, sustaining the dividend, or executing buy-backs – is going to be adversely impaired. So, the focus is, 'Guys, that's your key resource. Deploy it efficiently to customers and portfolios of customers that generate returns against not just the Group/PRA's view, but also take into consideration where there are significant differences, local regulatory requirements, so that you're generating an economic profit against local reg requirements so that you can upstream resources to the Group'.

Manus Costello

And you parcel back out the BSM profits, but not the bank levy charge.

Iain Mackay

The bank levy's a UK-oriented charge. There is nothing – if we tried to run that through the Asian business, a) there is no way on God's green earth you'd ever get the tax charge, so why encumber the business with something that is UK-oriented? And by the way, in three years' time, subject to a change in legislation, it becomes purely a UK bank levy.

Claire Kane, Credit Suisse

Just to follow up on the Group capital structure, I noticed in the last quarter – or since this reporting date – you've downstreamed £1.2 billion to the UK subsidiary, which I think added 50 bps to their ratio, which is now 11.8%. So, can you tell us how much of that was predicated on the recent discussion you had around your MREL requirements with the PRA? You said you had an update there. And what is their view around you meeting your MREL requirements before you're allowed to distribute potential surplus CET1, given that there isn't really much of a surplus at the MREL level?

Iain Mackay

Well, we haven't had that conversation, interestingly enough.

Claire Kane

I thought you said on the call that you had a discussion on MREL; you had an update from the PRA.

Iain Mackay

No, the PRA has provided guidance on MREL requirements overall, and there's obviously a consultation process with respect to internal MREL. But, no, the purpose of a capital injection to the UK business was to ensure that both the ring-fenced and the non-ring-fenced banks are appropriately capitalised from a common equity tier 1 perspective, when we implement ring-fencing on 1 July of this year. So, that is the point of ensuring that they're properly capitalised at CET1 level, and then simply downstreaming and positioning MREL in a manner that will be consistent with where we need to be by the end of this year, or by 2022.

Claire Kane

Do you think you'll have to downstream any more before the ring-fence goes live, or do you think it can generate the rest of the cash it needs to get to 13%?

Iain Mackay

Well, we'll capitalise both the ring-fenced and non-ring-fenced bank somewhere between 12.5% to 13% common equity tier 1. That's how they will start business on 1 July.

Claire Kane

Thank you.

Iain Mackay

Anything else from Hong Kong?

Steven Chan, Haitong International

I have two things, all related to Hong Kong. First of all, when you do the interest rate sensitivity analysis, have you considered a potential rise in Hong Kong Dollar Prime Rate and Savings Deposit Rate, because Hong Kong has this unique interest rate structure? Secondly, would there be any impact, or potential impact, on the net interest margin in Hong Kong if the HKMA pass these so-called TLAC guidelines, and then probably, you'll have to – I'm not sure whether you'll have to issue some additional TLAC instruments in Hong Kong for both Hang Seng and HSBC.

Kathleen Gan

So, I think slide 12 in the deck lays out the NII sensitivity, in terms of the change in the yield curve by 25 bps and 100 bps. So, that's the assumption that we're using for each of the currency blocs in terms of projecting the impact on NII sensitivity. So, in terms of how the Prime Rate is going to change, that really depends on when the Prime Rate's going to change, and that will then be looked at as part of the overall sensitivity analysis.

Iain Mackay

So there is more detail, I think, on page 110/111 of the Annual Report and Accounts, around the basis of preparation for that NII sensitivity. So, it is based on where we stand today, and beyond year 1, we've made no assumption around the behaviouralisation, in terms of how deposit betas might be impacted.

Kathleen Gan

That's right. And then your question on MREL – currently, with some of the MREL that is – or TLAC that is issued by the Group and downstreamed to us in HBAP, we would already have impact in terms of the NIM. For HBAP, it's roughly about similar ranges as Group, at about three to four bps on our margin.

Iain Mackay

To be clear, the strategy for issuance of TLAC/MREL is based on what we see from a regulatory perspective presently, that the issuing entity will be the holding company – so, HSBC Holdings plc.

Steven Chan

Can I have a follow-up on these Hong Kong Dollar Savings Deposit rates and Prime Rates? Have you done a similar sensitivity analysis – because Hong Kong and Shanghai Bank or Hang Seng, they have relatively more Hong Kong Dollar savings deposits. So, in case – if we started to have a rise in Hong Kong Dollar Prime Rates and Savings Deposit Rates, are we going to see some pressure on the net interest margin in Hong Kong?

Kathleen Gan

Yes. So, again, I think the analysis at this point – we're doing a shift in the curve by 25 and 100 bps. So, naturally when the rate rises we'll have to do similar analysis based on the book composition at that point, but I think page 110 and also on page 12 in the IR deck should give you a good sense of what the Hong Kong Dollar's sensitivity looks like.

Magdalena Stoklosa, Morgan Stanley

We've talked about the building blocks of your NII, and I just wondered whether you would do us the same favour from the perspective of your cost base. What interests me in particular is where you see underlying cost pressures, cost inflation, within the global context versus the regulatory side versus the cost savings. You've got a very useful waterfall chart on page 14. I just wondered whether we could take it forward at least one year out.

Iain Mackay

Well, I think based on jaws guidance of 1-2%, if you can work on the revenue line, which I think we've provided building blocks, that should help you put together a reasonably clear picture on that perspective, then at least in terms of the round, then it gives you some guidance on where costs are.

And that is informed by the fact that we've made very significant investments over the course of the last three years over and above what we would normally do, in the range of $7 billion, to improve overall operating efficiency in a technology platform, both front-end customer-facing, how customers interact with us as a Firm, as well as in the middle and back office, investment in people development, product development and overall process re-engineering, which has generated just over $6 billion of saves, which really are all reflected in the exit rate of 2017, with some of that to flow through into 2018.

You can see from the chart that we set out in page 21 on the Investor Deck that in virtually every market in which we operate we see inflationary pressures, but the goal of many of the productivity measures we've taken and will continue to take is to offset some of those inflationary pressures and try to create capacity for incremental investments in the Firm. And the extent to which we increment that investment will be informed by the objective of generating positive jaws for the Firm annually. So, jaws is not an investment criteria other than sizing the pool that is available for investment.

In terms of individual components, I think if you take the big part, we talked last week about how, for example, regulatory and compliance costs have reached just under the $3 billion mark, so about $2.9 billion, and we expect that, broadly speaking, to be fairly stable. Where we may see some very marginal benefits is the fact the Deferred Prosecution Agreement with respect to AML has – the charges have been dropped.

As a consequence, the Monitor's activities – although he will be with us as a Skilled Person under Section 166 with the FCA, we would expect through most of 2018 the scope of work that he will do at the request of the FCA will be different and less extensive, so we would expect to see some savings coming through there.

By the same token, we have entered into a new DPA with the Department of Justice on FX, like many other institutions. And although there will be some costs associated with that, we would not expect it to be of the scale at all that was experienced through the AML DPA.

So, in the round we've said that costs with respect to regulatory and compliance we'd expect to be broadly consistent and stable, certainly through 2018. Other factors that fall into that space obviously are completion of the projects with respect to ring-fencing in the United Kingdom and any costs that – and, again, we provide detail on those. And although they're not significant in the round at this time, we provide detail about significant items as to costs incurred with regard to Brexit.

But taking that as one component, albeit a relatively significant component – it's about 10% of the cost base – we see inflation in the vast majority of markets principally coming through labour costs. That's the single largest component we have, with 229,000 employees in the Firm and a growth trajectory which would see us adding to some. Not significantly, because, as I said, we continue to generate productivity savings in the Firm, but there are inflationary pressures which we would look to offset each year through those productivity savings.

Magdalena Stoklosa

So we have a tail end of Brexit costs and the ring-fencing costs in 2018 as such, but I find it a little bit of an inconsistency that when you talk to Citibank or JP Morgan, one of your kind of competitors, they actually talk about the regulatory costs on a three-year view coming down quite significantly. And I just wonder, from your perspective, is it the sheer complexity that you have to deal with that may delay that type of commentary?

Iain Mackay

There is certainly an element of complexity, but in the round the lion's share of regulatory costs, whether conduct or prudential, emanate from how we are regulated by our home regulator, the PRA. That is not to say that we do not have costs associated with stress-testing in about 60 other jurisdictions in which we operate around the world. And that is not a free activity. There is a significant investment in ensuring we comply and improve our capability against those stress-tests.

That being said, the most taxing of those stress tests emanate from the United States, the United Kingdom, Europe and, to a lesser extent, Hong Kong. The other stress tests that we undertake tend to be jurisdictionally specific in nature, informed by that local regulator. So, although a lesser significant component, it's not insignificant.

I think, realistically, if I was to suggest a three-year view, as we continue to deploy globally consistent technology and process around financial crime risk management – so, we're very clear in the commentary that we've provided in the Annual Report and Accounts and the Investor Deck that that job is not done, right? We've made great progress; we've met the obligations of the Deferred Prosecution Agreement, which is why the charges were dropped. But we clearly have more to do to attain the standards that we set for ourselves with respect for financial crime risk management. And we think it is extremely important for the Group to be able to do this and, in the longer term, a competitive advantage for us.

There is, however, still a couple of years of significant work that needs to be done in ensuring we've got consistency across the 67 markets in which we operate.

Robert Sage, Macquarie

I've got a quick question on some of your strategic update and various targets. And you've met most of them and exceeded a lot of them. One of the ones where you've fallen short is on the renminbi, and I think you said between 2-2.5 billion and I think you're running at about 1.2 billion.

Now, I was just wondering whether you could update your thinking around that: whether this is simply a delay in terms of getting there – I think you referenced low volumes last year – or whether it could actually be that the opportunity could be a little bit smaller than you'd previously thought.

Iain Mackay

Definitely not the latter. The opportunity is definitively there. However, our goal was set in that regard before the renminbi took a fairly significant reversal in 2016 and, as a consequence, the amount of revenue we've been able to generate from our leadership position from a renminbi internationalisation perspective has been somewhat less, but in terms of the scale of the opportunity in the longer term, given our number-one position – a very clear number-one position in terms of renminbi internationalisation across a range of products – the opportunity is still significant and probably expands further in terms of the Belt and Road Initiative.

And, again, when we look at the Belt and Road Initiative across our network in Asia, the Middle East and Europe, we're extremely well positioned and have a fairly healthy pipeline of opportunity building with respect to such initiatives. So, I think it is more a question of timing, Robert, as opposed to the scale of the opportunity. And that timing will be informed to no insignificant degree by PBOC and Chinese policy, broadly speaking.

Okay, Hong Kong, you had a question.

Katherine Lei, JP Morgan

My question is still on the operating costs, and then there's another question on the interest margin as well.

On the costs, is it right that the cost to achieve is actually higher than the annualised savings. So, does it mean that in 2018 and 2019 and going forward, we're going to see the costs to achieve maybe slow down and then the annualised savings would outpace the costs to achieve? So, this is the first question.

The second question is on the net interest margin, particularly in Hong Kong. I know HIBOR has been volatile, but, in our sensitive context on NII, do we have a separate NII test just for Hong Kong or in Asia regions, particularly related to HIBOR? And what's your outlook on HIBOR in 2018?

Iain Mackay

So, on your first question, I reiterate what we've said all along, the CTA programme will end at the end of 2017, and it has? So, there are no further costs to achieve, and what we are focused on delivering through the cost base and the exit run rates that you saw at the end of 2017 – having the capacity to continue to deliver productivity improvements in the Firm, quarter in, quarter out, year in, year out, that will help us offset the effects of inflation and create some capacity for investment.

We have within the overall cost base for the Firm and have had throughout the last three years an addition to costs to achieve of some $2.5-3 billion of what we call 'Change-the-bank', which is focused on specific new investment around product, technology, people capability within the firm. And that capacity continues through 2018 and beyond, but the cost to achieve was very much focused on 2015-2017, and that investment envelope and programmes came to an end at the end of 2017.

On Hong Kong, yes, we've got a sensitivity analysis around Hong Kong; it's incorporated in the sensitivity analysis that we've included in the Annual Report and Accounts and Investor Deck. And that is informed by the assumptions that we've documented in the Annual Report and Accounts. Clearly, it is sensitive to how HIBOR develops, and HIBOR – you know, we've set out before that HIBOR will be informed by how the peg performs and there's a technical construct around how the peg has to perform when the exchange rate between the US dollar and the Hong Kong dollar reaches a certain threshold.

You've seen how HIBOR has developed over the last four quarters. We track it pretty much every day of the week, but the assumptions we've retained are incorporated within the basis of NII sensitivity that we've provided.

Martin Leitgeb, Goldman Sachs

Two questions, please. The first one on UK/Bank of England stress tests and the second one on capital ratios within the UK.

And just, if I compare HSBC's performance in the 2017 stress-test exercise compared to that of 2016, the relative performance seems to be somewhat weaker compared to that of your peer banks, and I was wondering if… And the weakness doesn't appear to relate just to China and Hong Kong but a somewhat broader base. And I was just wondering, was there anything particularly punitive to what HSBC in last year's stress test?

Iain Mackay

Why do you think they include Hong Kong and Asia in the stress test? There's no other British bank that has particularly critical mass within the Asian marketplace, so I think it would be fair to say that it is to some degree orientated to how it might impact HSBC. And I think both China and Hong Kong – the depth of the stress that was applied in 2017 was particularly noted.

But, no, there are a number of factors across the UK and Asia broadly. We started from a stronger point, but it was informed by the fact that it was a more severe stress test.

Richard O'Connor, Head of Global Investor Relations

Just to add to that, Martin, it was a strange stress test, where you saw very weak GDP but also much higher rates, and that obviously had a big impact on Balance Sheet Management and AFS losses, so you saw quite big treasury losses on that assumption, which of course in real life you would expect BSM to avoid some of those as we go through.

Iain Mackay

Reposition.

Iain Mackay

And that is one of the challenges of the stress test, that you've got to go into it… There are limitations within how the stress test has to be prepared, and I think we've demonstrated a fairly robust track record of taking management action as we see things developing, as opposed for waiting for the crisis to hit us full face on.

And I think this is part of the ongoing conversation with the Prudential Regulation Authority. If the basis of preparation continues to be increasingly severe and limitations around the day-to-day management actions that a Firm can take, then is it entirely appropriate to mechanistically take the impact of the stress and apply it through Pillar 2A?

That is part of the process, which is a normal and sensible conversation to have with the regulator.

Martin Leitgeb

And the second question, just on the UK capital ratios. You hinted at 12.5-13.5%. Are we right to assume that you expect those entities that are ring-fenced and the non-ring-fenced banks to be essentially constrained by core tier 1 rather than leverage capital?

Iain Mackay

So, I think it's reasonable to assume that the ring-fenced bank would be constrained by common equity tier 1 and I think you can look at the non-ring-fenced bank and variously it may be constrained by either common equity tier 1 or leverage, okay?

Joe Dickerson, Jefferies

On the regulatory and compliance costs of $2.9 billion, how many employees full time are associated with that? And then, secondly, with single-digit balance sheet growth, revenue growth and assuming a stable impairment environment, you ought to be growing your EPS and at some point it seems inconceivable that the dividend per share you would just say 51 cents in perpetuity, so what's the thought around capital distribution from a hopefully prospectively growing EPS?

Iain Mackay

The guidance on capital distribution is exactly the same now as it was a year ago, 51 cents for the foreseeable future, and we'll consider buybacks from time to time. Until there is a floor on regulatory capital requirements, with clarity, or a significant pick-up in sustainable economic performance that flows through EPS, then I think we'll maintain a fairly conservative stance on this point, okay?

On the compliance, well, it does specifically within financial-crime risk-management, but that category also includes stress-testing activities, ring-fencing activities and so on and so forth, so it's between 6,000-8,000 employees, okay?

Chris Manners, Barclays

A couple of questions, if I may. The first one was just on Rates revenues in the fourth quarter. You've been averaging sort of $500-600 million a quarter for the trailing six quarters; you only printed $273 million. Obviously there's weak peer reporting; there wasn't much volatility. But should we be expecting that to pick up more to a normalised run rate or is there anything to call out in the quarter?

Iain Mackay

Well, as you know, Chris, Rates, along with Credit, tend to be a fairly volatile product line, so we have maintained our growth and market share in Rates and Credit over the course of the last two years. The marginal cost for us to maintain broad-based capability in Rates and Credit is *de minimis*, because the platform in which we manage Rates and Credit is the same platform as we manage Balance Sheet Management not surprisingly – and we manage Balance Sheet Management by jurisdiction.

So, we've maintained a Rates and Credit trading capability probably more broadly geographically than many of our competitors, which accounts for the fact that we've taken some share in that space. But, yes, it is a volatile space; it is a volatile product range, and we expect to see volatility in the revenues, and we saw it in spades in the fourth quarter.

Chris Manners

A second question, if I may, on asset quality. We haven't really talked about it too much, which I suppose is a good thing. A 27 basis point charge in the fourth quarter, obviously a couple of single names in there…

Iain Mackay

The only thing that counts in the fourth quarter. Those two names are it, basically. And if you looked at Global Banking and Markets for the year, there were lots of puts and takes, but in the round the entire LIC for Global Banking and Markets in the year were those two charges.

Chris Manners

So, can we ask you maybe a little bit on how confident you are about keeping the impairment charge at this low rate? And maybe are there any areas that you're looking at, emerging risks that you're concerned about in the book at the moment? Or is it all sort of plain sailing?

Iain Mackay

Across the Global Businesses and the different geographies, the credit environment remains very stable or, dare one say, benign. I would be much more confident predicting 27 basis points as opposed to 19 basis points as a percentage of annualised loans and advances outstanding.

Our historical average sits between 30 and 40, and I suspect over time there'll be some reversion to that historical mean. But at the moment there is… I actually haven't asked this question of the guys, but if we normalised the fourth-quarter charge excluding those two names, I don't know what the charge would have been, but it would have been pretty low again.

So, right now the environment, whether the UK, continental Europe, the Middle East, the Americas, Asia – very stable. I think we saw a little bit of tick-up across some of the corporate banking space in Asia in the fourth quarter, but, again, when you looked at it by sector, by product, nothing of note. So, it remains very stable.

James Invine, Société Générale

I notice one of your significant items was 99 million investment in new business. I was just wondering if you could tell us what that is and are we going to get more in that line over time?

Iain Mackay

I don't think we'll get more. We may. It just relates to a range of liabilities associated with investments that we've made. And we felt it was worthwhile singling it out as a significant item. But I wouldn't necessarily expect a great deal more to be seen on that particular line item, but it relates to liabilities that we've incurred with respect to a couple of investments we've made.

James

Are you willing to say where in the Group they are? Are they…? I guess they are new businesses. That's what you've called them.

Iain Mackay

No, I don't really want to go into more detail than that, no.

James

All right, okay.

Iain Mackay

They're Asian-orientated.

Alastair Ryan, Bank of America

Just on the UK, your accounts are often difficult to really get to, but the UK, as you report it – you don't really make any money, which isn't how you talk about it. And I know there is a lot of things in there, but you break out the Corporate Centre now, which is helpful. Q4, none of your businesses in the UK made money, as you reported. Q3, they made a bit but not much.

So, just how do we understand your UK? I'm not accusing you of not having noticed, but I'm just saying I can't really read what you're doing, because you characterise the bank as if it's performing relatively well; the numbers we get are that it isn't.

And I've got a follow-up on associates.

Iain Mackay

Yes, that's a perfectly fair question, Alastair. So, look, the UK includes corporate headquarters, so it includes the bank levy –

Alastair Ryan

Yeah, but you break that out in the divisional –

Iain Mackay

Yes, so in the UK, broadly speaking – and you'll see more of this as we provide data as we move through 2018 and into 2019 around the ring-fenced bank and non-ring-fenced bank, because we will provide more disclosure in this respect.

In the round, you see a ring-fenced bank, so Retail Banking and Wealth Management, Commercial Banking, Global Private Banking – which are profitable businesses that are generating a return on equity in the low teens – and a Global Banking and Markets business which is a major booking centre, has been historically, for Global Banking and Markets in the UK, which particularly in 2017 got nailed in the fourth quarter which adversely impacted the overall performance for the year both by lower income from a FICC perspective and approximately $500 million of loan-impairment charges coming through two significant names within the European and UK environment.

The other factor which comes in is that some of the costs are coming through Holdings, so the Corporate Centre with respect to Holdings debt and MREL outstanding up to the point that that is downstreamed into the operating entities, so there's a bit of a timing element within that. But I think it would be fair to say that this is an area where, as we work through 2018 and beyond, we'll give you more insight as to specifically what ring-fenced and non-ring-fenced are achieving within the UK.

Alastair Ryan

Thank you. And then just to follow up, so Bank of Communications – your value in use range improved quite a lot in Q4. Does that mean any potential impairment is more distant than you might have thought last time you updated us?

And finally you're in talks on an acquisition in Saudi still. Can you scale – if that happened, how big is it for you?

Iain Mackay

So, BoCom, I think the headroom is still about $200-300 million dollars, which I think is broadly consistent with where we were in the third quarter. As disclosed in the Annual Report and Accounts, we updated some of the long-term assumptions around that value in use model and that is not something – they are long-term assumptions, so it’s not something we’re going to do every quarter.

But those assumptions are informed by externally observable valuation points. There’s not a huge sell-side coverage of BoCom, but certainly the input from the sell side is one of the factors we consider as well as the actual performance of the business, the macroeconomic outlook from a Chinese perspective and the role that BoCom plays in that economy.

So, there were some changes to long-term assumptions that went in both directions. And what you’ve also seen, less so in the case of BoCom, but you’ve seen a few of the other Chinese banks, is that you’ve seen some recovery and improvement in their share-price performance over the fourth quarter of the year. It would be nice to see some of that come through the BoCom share price, which has been less noticeable than the likes of ICBC or Agricultural Bank or Bank of China, for example.

Whether it’s more likely or less likely, I hate to comment. Sorry, what was your other question?

Alastair Ryan

The Saudi merger.

Iain Mackay

Saudi – I can’t really talk about that. It’s still a consideration. Obviously, principally through our 40% shareholding of Saudi British Bank, have an important market presence in Saudi. Notwithstanding the fact that there are some present difficulties from a political standpoint, we continue to, in the longer term, see the benefits of some of the longer-term policies that MBS has put in place and seems to be pursuing, perhaps at a slightly slower pace than was first intended.

But we see Saudi as being an important market. We’ve got a good position there both as HSBC and as a shareholder of Saudi British Bank but also on a standalone basis. If there was an opportunity there with the right risk appetite and the right profile to build market share I think we would take it, and I think that’s probably all I can say at this point, but there is still – there’s a great deal of work to be done before a conclusion will be reached in that regard.

And any conclusion that is taken, by the way – we can only inform it to the extent that we’re a 40% shareholder of Saudi British Bank. So, clearly we’re an important part of that decision, but we’re not the only part of that decision, clearly.

David Lock, Deutsche Bank

Just on GB&M, I think in the past in these meetings you’ve talked about $20 billion of model changes that are in train. I just wondered what the timing of that is and in terms of movement –

Iain Mackay

So, in fairness to the teams at the PRA, they’ve got a lot on their plate at the moment between ring-fencing, which is obviously a significant focus, and working through new guidance from the BCBS and the like.

We have a number of models that have been with them now for a number of months, principally in the area of Global Banking and Markets. Those models benefit from improved granularity of data, improved collateral management, we think improved modelling from an IRB perspective – but until those models are approved by the PRA we won’t realise those savings.

David Lock

And just to follow up, you've talked in the past about moving some of the business from the UK to the French subsidiary. How is that progressing, particularly given the clock is ticking?

Iain Mackay

So, there's not so much about moving business, although that may well become a consideration as customers may wish to have their business recorded with a European entity as opposed to one headquartered in the UK, but what is underway at the moment is realigning the branch network, our continental European branch network, which is presently part of HSBC Bank plc, and realigning that to be part of the French Bank, so HSBC Bank S.A., and the branch network then being obviously run and controlled out of the French bank, subject to European regulation.

So, that – we've received a number of approvals. We're working through it branch by branch. I think we've now got approvals for just over half of the branch network, which covers about 18 countries in continental Europe, so the process of realigning them to our French bank is now underway. As you would imagine, the ECB and the PRA have broadly been very supportive of that activity. So, from a reporting of the results, from a geographic segment perspective, it won't really change except it will be all part of the European geographic segment. But from a country perspective, then that obviously will change as we complete that realignment over the course of the next year or so. And, as you look at French results, they would incorporate – on a statutory basis, they would incorporate the results from the European branch network.

David Lock

And would you be willing to comment on what capital requirement you would need for the French business? Just because, I appreciate the comments about the UK ring-fence and the non-ring fence, but it strikes me the non-ring fence bank in the UK is, going to become far less important than probably the French business going forward if these transfers do happen, as suggested.

Iain Mackay

I think a great deal depends on what Brexit looks like. The extent to which there is equivalence between UK and continental European regulation, I think, will, possibly more than anything else, inform the size of the balance sheet of HSBC Bank plc and the extent to which it is more or less important overall, from a Group perspective. So, I don't particularly want to speculate too much on that, because we don't know how Brexit is finally going to be shaped, but the action we are taking is to ensure that we've got both the legal entity structure, which would benefit from having HSBC France, the product of the CCF acquisition, making sure it has the scale and capacity to support customers across continental Europe. It is a well-capitalised bank at the moment. You could make the case that it is slightly over-capitalised at the moment, but we will not extract capital from it, because we recognise the demands on that capital will likely become somewhat more pronounced over the coming quarters and years. But our focus, at the moment, is just making sure we have the legal entity structure, the product capacity and the capital capacity to support customer business on an uninterrupted basis in whatever shape Brexit ultimately takes.

Yafei Tian, Citi

A couple of questions. The first one is on page 29 of the presentation pack, related to the profitability of the Corporate Centre. So, when I look at the RoTE across different business lines, the Corporate Centre seems to be the only drag pretty much now every other business has done well. The question is: how should we think about a sustainable RoTE for this part of the business and what has affected 2017's profitability that will not be recurring? That's number one.

Iain Mackay

Okay. So, look, the Corporate Centre is – what makes up the RWA and capital composition or capital consumption within the Corporate Centre is principally our associates, right? So, for the purpose of the RoTE calculation, as was pointed out a little bit earlier, the Balance Sheet Management is moved into the businesses, because they are both the provider and users of that liquidity. However, what remains within the Corporate

Centre is our investment in associates, so, principally, BoCom, but also SABB and a couple of other small ones. What also remains in there is our Legacy Credit portfolio, which has got 20 billion of RWAs sitting in there. And then what we have, from an operating expense perspective, is the net of what runs through a number of service centres globally that all clears through Corporate Centre and any over or underperformance within those centres sits within that Corporate Centre, and then the costs associated with issuance of capital instruments or senior debt, before it is then downstreamed into operating entities for the Group. So, the principal factor is that we've got a number of legacy portfolios within the Corporate Centre and the bank levy booked within the Corporate Centre, which largely informs the return equation within that Corporate Centre. As we clear out Legacy Credit, as we downstream capital instruments and MREL to the operating subsidiaries, as we continue to drive overall cost discipline within the firm, the position within Corporate Centre, I think, will become (a) more stable and (b) less of a drag on the Group overall. So, there is a strong focus on ensuring – and one of the reasons we put the Corporate Centre together was to pull out of those businesses aspects of legacy that we were in the process of running down, so that we could get a clear look at the other four global businesses on an ongoing performance basis.

Yafei Tian, Citi

So, maybe over time that line would become around 0% in an ideal situation, right?

Iain Mackay

Well, I think, ideally over time we'd like to see it slightly positive, because actually BoCom generates a reasonably attractive return on investment for the Group as does Saudi British Bank, but there are also a significant amount of corporate costs that sit within the Corporate Centre, but as we clear out legacy we'd clearly like to see that turning into positive territory.

Richard O'Connor

Slide 11 has Corporate Centre, US run-off Legacy Credit split out

Yafei Tian, Citi

Okay. The second question is on page 4, when I look at the PBT by geography, see a very nice recovery in North America business, which has always been a little bit under-performing for the Group. I just wanted to get some colour around the outlook for the North American business and your strategy there. What kind of growth profile do you see?

Iain Mackay

Well, I think John Flint would happily acknowledge that one of the – you know, if you were to describe dealing with the DPA as perhaps one of the elements that Stuart had to put a great deal of focus and attention on, I think John would happily say that improving the overall performance of our Americas businesses and specifically within that, the United States, along with continued performance improvement in continental Europe would be perhaps those areas that occupy quite a lot of John's time, looking at it from the starting point. So, the US performance clearly improved significantly and, by that, I mean the US bank. So, if you did a comparison of 2016 over 2017, the US bank's performance in 2016 was about US$390 million and then there was about $180 million of profit from the run-off portfolios in HSBC Finance. When you look at 2017, there's about $170 million, $180 million loss from the run-off portfolios and in excess of $900 million, $920 million worth of profit coming from the US bank. So, a significant performance improvement. Part of that is informed by the fact of much lower loan impairment charges on the back of greater stability in the oil and gas sector in the United States in 2017 versus 2016, but also an improvement in overall revenue generation and cost management within that business. The intent, as was set out in the strategy update back in 2015, is to continue to grow and improve the performance of the Retail Bank, Commercial Banking and Global Banking and Markets businesses in the United States. Progress has been made in that regard, but there's a great deal more to be done. If the team can continue to build on the progress they've made in 2017 in terms of revenue generation, with the right risk appetite around it and good cost management, then that'll be a step in the right direction. But I think it is fair to say that the US continues to present, in terms of its overall capacity, capacity to generate returns and pay a dividend from its profits continues to be a challenge that we will put significant attention on.

Yafei Tian, Citi

Okay. Maybe finally, on capital and all these instruments that HSBC is using to meet the MREL requirement, AT1 and MREL securities, to what extent are you taking advantage of the current low interest environment to issue more or front loading some of the issuance?

Iain Mackay

We had very good experience through 2017 in terms of seeing both the demand but also the cost associated with Additional Tier 1 and MREL TLAC instruments over the course of the year pricing improved significantly. If there is, and we believe there is, an opportunity to continue to take advantage of that, then it would be our intention, over the course of the next few days or weeks, to launch a couple of offerings in that regard. So, it is very much about meeting the regulatory requirements. We are in a good position in that respect. We like to maintain a small buffer at each of common equity tier 1, tier 1 and tier 2 levels to allow for any stress which may result in volatility in RWAs, any growth within the business, but I would emphasise that a small buffer at tier 1 and tier 2 is where our focus is and, at the moment, we are particularly focused on making sure that we meet our requirements both at 1 January 2019 and at 1 January 2022, as we presently understand them.

Tom Rayner

Just a couple, please, Iain. Just on investment. When you talk about investment it does seem very much what's actually expensed through the P&L. Is there any element of investment over the next few years, particularly with regard to digital and IT, that may be capitalised and, therefore, we won't see in the P&L initially, but may have a capital impact, etc., a build up? And how material might that be?

Iain Mackay

So, clearly in the technology space it tends to be more material than any other. I do not have the broad percentages in mind, but we can come back to you on that one. But yes, there is a component, particularly from deployment of servers around big data. So, as you build server capacity, the hardware associated with that. We've clearly got a policy around software capitalisation. That being said, there is much more – there's a much higher proportion of what we do, from an investment of software now, which is purchased off the street as opposed to internally developed. We've made a very significant switch, over the last three years, in focus around self-developed versus buying best in breed and then deploying that, pretty much as is, across the Group. But yes, there is a component of it is capitalised and that has, equally, been the case over the course of the last three years.

Richard O'Connor

Pretty consistent capitalisation and depreciation over the last three years.

Iain Mackay

That is a good point, Richard. It's been broadly neutral from a P&L perspective.

Tom Rayner

Okay, thanks. And then, just finally, on AT1 programme, can you just update us what your plans are again in the first half? Just how much you've done, what you're intending to do by the interim –

Iain Mackay

So, we talked about $5 to $7 billion last week and we'll target – AT1, sorry – we'll target the lower end of that range and if there is good pricing and demand, we may well take the opportunity – and it will be opportunistically

– to move to the top end of that range, but five will be the focus of our efforts over the first half of the year. And then, I think, more broadly, talking about MREL, I think the range that we've talked about is 60-80. I think that range remains consistent. As of the end of the year, we had about just over 40, from an MREL – perhaps 43 out there. I think we did about 12 last year, from an MREL qualifying perspective. Our expectation is we'd move up to inside that 60-80 range, so we'll have something similar, possibly slightly more, in terms of MREL.

Now, the other thing to bear in mind is there's an actual refinancing that goes in. We've got a number of capital instruments the regulatory capital value of which is beginning to dissipate over that five-year amortisation period. And when we look at the economics – and we are looking at the economics, so we look at the cost associated with that, the pricing opportunity in the marketplace now and whether or not we can realise savings in that respect, and we believe we can and will continue to refinance and do some liability management as the opportunity presents, to take a bit of cost out of the P&L as well as meeting regulatory requirements.

Richard O'Connor

Target for full year 2018: $5-7 billion of AT1, $12-17 billion of MREL; expect to do a chunk of that over the next 2-3 months

Gavin Francis, Group Chief Accounting Officer

Internally generated software is disclosed in Note 20 of the Annual Report and Accounts.

Iain Mackay

There we go, note 20 on page 227 of the annual report and accounts. Sorry, I didn't remember that footnote, Gavin. I just didn't study hard enough, I apologise.

Adam Lee, UBS

Just a quick question on market share as it pertains to products outside of Retail, which you've been pretty clear on your target areas there. Just on lending and other products, where you're seeing some tailwind still existing in the business and where things are kind of back to steady state and really it's back to the demand equation.

Iain Mackay

I think, you know, we saw very good momentum over the last couple of years in Global Liquidity and Cash Management. We've got probably the best offering in the marketplace, from a technology and product range perspective, in that space and probably the best market presence that has consistence, from a cash management perspective, for corporates. I think we'll continue to see momentum. I would be somewhat circumspect if we see the same growth rates as we saw in 2017, which were truly quite remarkable, by Diane and the team, in that regard. It would be very encouraging to see the same stability that we've started to see, touch wood, emerge in Global Trade and Receivables Financing. I think there's still a bit of margin pressure in that space, but volumes are, I think, a little bit more stable and dare one say slightly positive. And as commodity prices stabilise and improve as, again, as we've seen over the course of the last couple of quarters, that improves the overall volume and margin on those products.

I think, from a corporate lending perspective, again the breadth of the network supports growth and, clearly, the headline numbers that popped out in 2017 were, broadly, in Asia and the UK, because they are the two largest markets – they're our home markets and they're the markets in which we've got the greatest presence. But there's been good progress made in the Americas, across Mexico, Canada and the United States, in 2017 and notwithstanding some repositioning, from a risk management perspective, the Middle East held a pretty stable position in that regard. So, I think, you know, we go into 2018 with a reasonably stable position and an expectation of mid-single digit growth and that will largely be informed just by the scale of our UK and Asian markets, particularly Asia, and how go those markets will largely inform how we go, from an HSBC perspective. But I would, in no way, detract from the progress that the teams in each of Mexico, US and Canada have made. Canada's back generating a return on equity above – you know, in low double-digits, just over 13% this year, which is recovery notwithstanding higher capital requirements, it's recovery back to something resembling normal and our Canadian business is moving along quite nicely. So, hopefully, a reasonably stable economic environment in the US but, as you know, there's, I suppose, some geopolitical challenges there that we might encounter, but at the moment it's fairly stable. So, I wouldn't detract from any of the efforts made by our many businesses, but the large businesses of Hong Kong, further afield, Asia and the UK, will, to a significant degree, inform how the Group moves forward.

Adam Lee

Thanks for the colour.

Iain Mackay

Okay. Thanks very much for your time this morning. It's always a pleasure. Thank you.