Transcript

Interim Results 2018, Equity Analyst meeting

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

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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

Why don't we just get straight into questions, if you introduce yourself and the name of the firm you're with, that would be greatly appreciated.

Alastair Ryan, Bank of America Merrill Lynch

Alastair Ryan, Bank of America Merrill Lynch. Just a question on Hong Kong today. Another great set of numbers. There's a lot of decisions to make now with where rates have moved recently, that presumably – so this is part one of the question – presumably the move in HIBOR should be good for you, all things being equal, in upcoming quarters, because we wouldn't have expected to see the full benefit of that last quarter. Part one, is that generally true? But then part two, obviously now with rates higher you're hitting these ceilings in your mortgage pricing, so you're getting questions of what you do with Prime. You're incredibly liquid, but the rates you're offering on savings and time accounts are generally very low. So how are you thinking about the levers you pull there, how much you keep versus how much you pass through to customers? What's the balance between asset growth versus keeping deposit margins in?

You talked about that in April, but there's already been quite a lot of movement in rates since then, so allthose questions again, please.

Iain Mackay

I think I'll let Kathleen take this, because she and the team in Hong Kong are living with it day-to-day, but there's obviously a balance between ensuring it's not just the overall deposit base in its entirety, but it's the currency composition of that, obviously, and then the demand for customer financing that then sits behind that. So the share of interest rates and depositor betas is clearly an important component, and the competition for US dollars is a little bit hotter, certainly than it was.

Around how Prime is set, that is informed by the market. That's commercially fairly sensitive information. It's not us who drives that. We're clearly a large player in the market but it's not us who decides unilaterally to move Prime at any given point in time. But Kathleen, perhaps your perspective from Hong Kong on this would be helpful to everybody.

Kathleen Gan

I think you've kind of addressed most of it, Iain, as you said that the timing of when we're going to raise rates really depends on how HIBOR rates are moving , but also against how much liquidity there is in the system. The exchange rate continues to go up to hit 7.85, HKMA steps in to mop up the liquidity. We've seen that action taking place in the last six months, from 180 billion aggregate balance in Hong Kong dollars, to slightly more than 100 billion. And that's still quite extensive if you compare against history, where I think Hong Kong dollar aggregate balance was around 10 billion. And that's a long time ago.

I think also if you look at historically, rates didn't really move until the spread between Hong Kong dollars savings and HIBOR was probably something in the range of 200bps, and we're still not quite there yet, because HIBOR has come down a bit again. And yes, it did go up quite a little bit to about – difference of slightly more than 200bps in June, but that's very much driven by IPO activity, so it's very, very temporary. So I wouldn't look at that as an indication. So again, I think you need to monitor the market closely, which is what we're doing, but it's really hard for us to predict when that's going to happen.

Iain Mackay

And the dynamic in terms of how this is managed, which is consistent around the group, is we've got an ALCO that meets at least monthly within each of our operating entities. Those are overseen by Group Treasury, and they all operate within a pretty consistent framework, and the people that sit in ALCO are the global business leads in each of the markets, the CEOs, CFO, heads of assets and liabilities, capital management and BSM. And so there is a trade-off that needs to be made between each of the businesses.

So an example quite recently in Hong Kong is that the Retail Banking and Wealth Management was perfectly happy to keep depositor pass through here really at a very low level, because it clearly supported profitability in the Retail Banking and Wealth Management business. But for some of the factors that Kathleen mentioned, it was beginning to influence overall US dollar – particularly US dollar – funding and availability, and so through the ALCO at a legal entity level they're sitting down and making the trade-offs, directed by the local CEO and the CFO, which obviously is fed back up to the global level. But at a local level, there's sometimes trade-offs that need to be made about retail banking and commercial banking changing their rates in terms of what they offer depositors, to move the overall position of the local entity balance sheet supporting activity in the right place. That fairly constant activity of balance sheet optimisation goes on.

Alastair, the point that you make is absolutely on the money. It's on the money all the time, not just in the current rate cycle, of those trade-offs having to be made and decisions having to be made as to the dynamic between what the balance sheet looks like, how that creates the capacity to support customer activity on the asset side of the balance sheet, and actions we need to take through each of the global businesses to make sure that the liability side supports that, both in terms of tenor, currency and then there's obviously an implication for profit generation within the firm.

Isabel Dobreva, Morgan Stanley

My first question is on your rate sensitivity, because in the new updated guide on sensitivity in the US dollar curve was lower, I know you've mentioned it's to do with US dollar funding availability. But some of the other currency blocks, like the pound, were higher. So could you give us some colour on what drove that?

And then my second question is on loan growth in Hong Kong. How should we think about the impact from the recent move in the yuan, on your loan growth in Hong Kong?

Iain Mackay

On the first one, the drivers of the dollar sensitivity are threefold. We've talked about one of them, depositor betas. There's a little bit more pass-through to customers than was the case the last time we spoke. Secondly, there is, with movement, with normalisation in the rate cycle, we are seeing depositors in a bit of a transition from demand deposits to time deposits, which I think is entirely predictable and expected at this stage in the rate cycle. There's a third element which was the change in composition of the deployment of assets into balance sheet. So there's more – certainly in this quarter, there's been a little bit more from the surplus liquidity position going into trading assets thancredit and lending. So those are the main influences.

In terms of sterling and euro, it's in the roundings. There's nothing of real significance there, that's really worth drawing your attention to.

Richard O'Connor

Just on sterling, the formation of the ring-fenced bank has increased the sterling sensitivity a little bit.

Iain Mackay

Yes your second question was Hong Kong loan growth. Impact of the yuan and that, we're not really seeing much of anything. Kathleen, do you have a perspective on that? The impact of movements in yuan recently, so you've seen yuan movements certainly against the US dollar, to a lesser degree reflected against the Hong Kong dollar. Certainly we've had no feedback from businesses that they expect that to have a material impact on our ability to continue to grow the business. I think there are a wider range of considerations, which is what sits behind the movement in the renminbi, and that almost certainly is informed by the tariffs regime and how that's getting escalated in the dispute between the US and China on trade conditions in general. And I think that's certainly the key driver, and certainly the market would inform this being the key driver in terms of movement in currencies, not only, by the way, in the renminbi. In terms of that translating necessarily into a direct adverse impact on our ability to continue to grow the business in Hong Kong, I think the wider political construct is probably the one that needs to be watched more closely, as opposed to the specific impact on the currency.

Richard O'Connor

We continue to see, as we said last time, a second half slowdown in the very rapid growth in Hong Kong loans. 13% year-on-year. There's normally a second half slowdown, seasonally, so we expect that this year. Obviously it continued very strongly in Q2, so let's see where we get to. But normally, there's a seasonal slowdown.

Iain Mackay

Any questions from Hong Kong?

Yafei Tian, Citi

Hey, this is Yafei from Citi, having a question around the sterling. So looking into second half, given how the sterling has been depreciating, has HSBC changed the hedging position since reporting last time? Can we take the sensitivity that we have seen in the first half as a guidance in terms of how it will impact capital, and the book value in the second half?

Iain Mackay

We've not changed our approach. We've got a structural hedge against the net investment position in sterling. That's informed by the RWA composition. Basically US dollar RWAs sitting within the UK legal entities is something we're monitoring very closely, in terms of a change, in terms of how that hedge is structured and the degree of coverage that we've got from it. There's no change at this point. Clearly if we continue to see significant weakening in sterling versus the dollar, then we'd expect to see some impact of that flow through. But in terms of a fundamental change in strategy to hedging, the structural position in US dollars on the UK balance sheet, there's no change.

James Invine, Société Générale

Good morning, it's James Invine here from SocGen. I have a quick two, please. The first is just a follow up on the rate sensitivity. Have you still got that feature of the numbers where the revenue sensitivity is higher than the net interest income sensitivity, because of the trading book? I was just wondering if you could give us a size of that for, say, a 100 basis point movement.

And then the second question is just on your investment plans and you've talked about jaws and so on, but how quickly can you adjust the cost line? So clearly you've talked about the revenue line, your confidence for it in the second half. But actually if it comes in weaker, for whatever reason, then if you feel the need to do so how quickly can you pull back the investment spending, or does it take you quite a few quarters to do that? Thanks.

Iain Mackay

Thanks, James. On the first point, I'm not sure there's anything of note, is there, Richard?

Richard O'Connor

Just to say the shift in the second quarter to trading income versus bank was about $100 million, but there's no overall change apart from that.

Iain Mackay

On cost discipline investment management overall, the flexibility that we've demonstrated over the last few years remains intact. The cost base for the second half of the year includes those investments that are in flow or could be initiated in the second half of the year, is pretty much in line with the first half of the year. That's the guidance we've provided. That's what we'd expect, ex the bank levy. Our focus is on growing the business, but should that growth not manifest in the second half of the year then the propensity of a cost base of more than $33 billion is significant.

We are reforecasting through the global businesses, and monitoring any volatility in valuations through the Corporate Centre, on a very regular basis, dare I say almost weekly at this point in time. The forecasting around retail bank, commercial banking, private banking, has remained very consistent over the course of the last three or four months, and when I say I mean forecasting though the end of the year, and now beginning to look at first and second quarter of next year.

In Global Banking and Markets, the majority of product lines are consistent, but there's clearly some lower numbers coming through the Rates and Credit businesses in particular. As we've forecasted through to the end of the year, we've haircut out forecasts for fixed income FICC, and that's simply to maintaining that cost discipline prioritisation around investments for the second half of the year, such that we're not making investment or spending decisions based on an overly-optimistic view of what could be accomplished within Fixed Income, Currency and Commodities.

So I think we've got a reasonably prudent outlook for the remainder of the year, but should there be events that emerge over the coming weeks that suddenly have an adverse impact on how the businesses are forecasting revenues through to the end of the year, and into the beginning of next year, then out of our cost base for the second half of the year, which represents $16.5 billion, nearly $17 billion worth, to be able to have some flexibility around delivering positive jaws is very much within our grasp.

That discipline is what John very much wants to maintain in this firm. It took years to develop that discipline and demonstrate frankly, to the marketplace that there was a grip around cost management and investment decisioning within the firm. It is fair to say that John does not want to lose that discipline which is one of the key reason why jaws remains one of our guiding principles within the firm.

Martin Leitgeb, Goldman Sachs

Good morning, Martin Leitgeb from Goldman. Two questions, please. The first one on the mortgage strategy in the UK, and I was wondering if you could share what level of approvals market share you have in the UK over the past two quarters, the first quarter, second quarter, if you have it at hand? I was just trying to get a sense in terms of the new platform coming live at the end of the fourth quarter, and accessing a larger share of the intermediary network in the UK, to what extent it has led essentially to an acceleration of the growth here.

And the second question, just more broad on Brexit, obviously the deadline approaching eight months from here. I was just wondering if anything has changed in terms of your preparation with regards to Brexit and what you see as the main risk for the franchise. Thank you.

Iain Mackay

Richard, you've got all the markets data in front of you, from a mortgage perspective.

Richard O'Connor

Yeah, the market share completions, Q2, was 7.5%, and the market share of approvals was 9.4%. And that's a step up from just over 7% for both in Q1.

Iain Mackay

Yeah. So where we are on the platform, we now have just under 60, I think it is, intermediaries now operating on that platform. That gives us visibility to more than 80% of the intermediary market. Based on the latest input from Ian Stuart and our team, they think that will probably top out round about 90% of coverage of the intermediary market. And going beyond that, I think the view is the cost benefit of bringing more onto platform, at least at this point in time, is probably marginal at best. I think the platform has been well-received now by the intermediaries. I think Ian Stuart, and Stuart Haire who leads the Retail Banking and Wealth Management business in the UK, would be the first to say that there is still a significant amount of work to be done in terms of reducing cycle times in terms of mortgage approvals for the customers, and Ian Stuart and Stuart Haire, are – it sits fairly high up on a very long list of Ian's priorities to work on in the ring-fenced bank as it gets going.

But overall that's going well, I think. Market share in stock has moved from 6.2% to 6.3%, from the first quarter to the end of the second quarter. And the risk appetite remains consistent. So the growth we are getting, quality-wise, is very consistent with how we build the book so far.

On Brexit, no changes. As we led up to the referendum a couple of years ago, the work we did in the lead up to it and immediately thereafter was very much informed by what we would need to do to continue to support customer business in a hard Brexit, so worst case scenario. There doesn't seem to be much in the way of greater clarity as to what the outcome could be at this point in time, two years later. Let's not get into that debate. But how we have been implementing our transition requirement has been entirely consistent with how we set that out a couple of years ago.

The work that is in process is around legal structure of the European network. So branches that were previously branches of the UK bank are being redesignated and appointed to become branches of HSBC France. That is well underway, with the appropriate approvals from the ECB and the PRA in hand. So that work is progressing very much as expected. It's going well. We have approval both from the ECB and Polish authorities to transform our Polish subsidiary into a branch, and that again will become part of the French bank. And the work that we're doing from a technology and product perspective is simply to ensure that those products and services that we provide for customers trading across Europe out of the UK bank can be replicated and served and supported both from a frontline and support function perspective through the French legal entity and the European branch network. So that work – so if you like the infrastructure work is up and running, full steam ahead, tracking according to the programme plan that we have in place. What we have not started doing at this point in time is any significant transition of personnel across to the continent. And that will be informed – because the majority, the significant majority, of the up to 1,000 heads again as informed by the degree of hardness of the exit, will be largely front-end, customer-focused, and it will be informed by when customers express a desire to start booking their business in HSBC France. At this point in time, although we do have some that have moved in that direction, that number is small, relative to the customer base of our corporate businesses as a whole. But we are very much tracking to be ready to support that transition when clarity and time is upon us. But no change, literally, since day one, other than the nitty gritty of the project management day-to-day, nothing has changed.

Next question Manus.

Manus Costello

Manus Costello, Autonomous. Jaws guidance. You used to talk about 1 to 2%, now you talk about 1% jaws. Are we now just positive, or are you still confident about 1%?

Iain Mackay

We're still tracking towards 1%. We talked about a little bit of softness in markets revenues, which is maybe making 1% a little bit more difficult, but we're tracking to positive jaws. I think as we look beyond 2018, we would expect that to widen out a little bit, but that's still the guidance we're tracking to. If there's a bit of weakness in Markets, it might be a nudge below 1%, but it'll be heading in that direction.

Manus Costello

And just on that point about Markets, and on your confidence in delivering this, because if I think back to Q4 last year, you had a significant drop in GB&M revenues and the costs didn't really adjust that much. And I'm trying to understand your confidence in jaws, coming into the second half. Is it because you've just taken a haircut to your revenue assumptions, so you've got a very cautious revenue assumption in there, or is that you've got an earmarked flexibility and spending that you didn't necessarily have last year, because we didn't see that relationship last year.

Iain Mackay

No, but you did see positive jaws for the full year last year.

Manus Costello

For the full year, yes.

Iain Mackay

Which is always what we said we were going to do. Which remains what we're going to do, just to be clear. It's both, to be clear. We have, and we always have, a pipeline both of investment spend and if you like other discretionary operating expenses, from the mundane of managing down the level of travel that ourselves and our colleagues around the firm undertake in the latter parts of the year and narrowing that down to the essential as opposed to the desirable, to just managing the overall pace of hiring, for example, because we do find in this firm that when we get towards the end of the year there is a high degree of enthusiasm for ramping up headcount for things that they'd like to get going on 1 January.

So there are a number of quite tactical moves lined up that if we see softness over and above that, which we've allowed for and incorporated in our forecasting, Manus, we'll take those actions. Now, as we came through the third and fourth quarters last year, we had a good line of sight to – and I hope the line of sight we've got this year is equally good, because that would make life considerably more comfortable going through November and December, but we've a good line of sight to achieving the positive jaws we'd targeted. And we have a number of investments we'd highlighted from the second quarter of last year that we wanted to keep momentum around, and that was something that both Stuart and Stuart with John, recognising it was going to have an impact on 2018 and beyond, that we wanted to keep in the pipeline and on track.

But yes, we – one of the things that we developed as part of our operating plan last year was asking the global business and the functions to identify that if revenues – to build a sensitivity analysis around revenues, and if revenues came in softer, what are the actions that you have in the pipeline with respect to costs and investment management and prioritisation. We did that for 2017. We did that for 2018. And we will do that again, I suspect, for 2019. But – and then we revisit that at least quarterly, in terms of how's revenue tracking against the forecast for the full year, where there are areas of potential softness, and if any of those areas of potential softness are looking a bit mushier than we would like, then we go back to the businesses and the functions and say, 'We would like you to go to those lists of actions you said you could undertake, and start taking them on.'

Robert Sage, Macquarie

It's Robert Sage with Macquarie. It's quite a minor question, actually, but I was just wondering about your strategy towards Saudi Arabia. There's obviously the proposed merger, and RBS think it's going to take place probably in the first quarter next year, or something like that. But I was just wondering, in terms of how you see yourselves getting bigger within that business, whether you're going to be diluted as a result of this transaction, whether it will still continue to be associate accounted.

Iain Mackay

Yes, thank you, Robert. So we own 40% of Saudi British Bank. Based on how the transaction may be structured, we would expect to see our share in the combined entity diluted to in the range of 30%. But we would continue to have a significant representation at the board of the combined entity and we would expect to continue to have a management contract similar to that which we have operated under with Saudi British Bank for many years. And on that basis we would expect that should this merger go ahead, we would expect to continue to account for it as an associate, under the equity method of accounting.

Victor Wang, CICC

This is Victor, and my question is, if you look at the geographical breakdown of the revenue and profit, apparently the vast majority of the past two years of the bank's profit is made in Asia, and clearly you have a lot of moving parts in this region related to trade. I would like to hear your view about – in terms of the sensitivity of that and the impact on your capital allocation being increased in these countries or in these regions. This is my first question.

The second question is, HSBC is by far the largest and also the most successful foreign bank in mainland China, operating in around 60 cities onshore. In the past six months, for whatever reason the Chinese authorities have sped up the opening up policy in the financial industry, to allow foreign banks to have more, easier access, and a wider range of business. Will that also further encourage HSBC to allocate more capital into mainland China? This is my question. Thanks.

Iain Mackay

First of all, I'd like to thank Kathleen and Peter for continuing to generate lots of revenues and profits in Asia. Look, we set out in the strategy in 2015 and then reemphasised again a matter of seven or eight weeks ago, that it is our intention to continue this pivot to Asia, to allocate capital to the growth of our businesses in Hong Kong and mainland China, with a particularly strong focus on the Pearl River Delta, in ASEAN countries and the sub-continent, to name but a few. And Peter and the team are delivering against that strategy.

I think, although starting from a very small base, the growth in terms of customer numbers, credit cards, corporate relationships that we're building in the Pearl River Delta is encouraging. The growth overall in mainland China, moving beyond the Pearl River Delta, is very much in line with expectations, and I think David and the team are doing a great job in mainland China, so we will continue to support the development of a 100% owned business on mainland China. We obviously do have a 19.03% investment in Bank of Communications, and that represents in terms of reported profits a significant proportion of the overall Group's profits, and that is an investment that continues to be marginally accretive for the Group overall and provides us with around $600 million worth of cash in the form of dividends each year.

So mainland China is big and important, both in terms of what we do as a 100% owned set of activities – or at least majority-owned activities – through for example our broker dealer HSBC Qianhai Securities, but also through the bank in mainland China and BoCom.

So the intention is absolutely to follow through with the strategy and continue to allocate capital to those businesses that represent attractive returns on the allocation of that capital within those markets, and to build the business. As also set out in the strategy, there are a number of businesses which we see as being vitally important to the network, where turnaround activities are well underway, where we need to improve their returns. The best known of those is probably the US, followed hard on the heels by our French business, where we really need to improve the performance of our Retail Banking and Wealth Management business, most notably. And then if one were to add one to the list in terms of improving returns at a local entity level, the non-ringfenced bank in the UK, broadly speaking our Global Banking and Markets business, has more work to do, and they're in process of doing that work in terms of improving the overall returns emanating from the business being conducted through that legal entity.

But look, there is no change to the strategy that we set out seven or eight weeks ago, which builds on the strategy we talked about back in 2015, and provide refinements around that. I think we can clearly see there are elements of that that are being well-executed and delivered against by the Group, and there are a number of areas which you are all equally tuned into where there is more work that is required. But no changes in that regard.

Katherine Lei, JP Morgan

Hi, Cathy from JP Morgan. I have a question on loan growth, because quarter over quarter loan growth is around 2.7, close to 3%. But usually I would say when in mainland China liquidity is tight there is more growth opportunity for Hong Kong. Does it mean that growth, at least from Hong Kong, will slow down on the loan side?

Kathleen Gan

Yes actually, we continue to see a strong pipeline. If you look at the performance of Hong Kong, it continues to remain strong in terms of the loan growth. So not the kind of impact that we've seen yet. What we need to do for mainland China is find ways to generate more funding to be able to support the loan growth, but even in mainland China we're seeing a pretty strong pipeline.

Katherine Lei, JP Morgan

Okay, thank you.

Iain Mackay

And, Kathleen, sorry going back to Victor's second question about mainland China opening up the market… Look, one, I think it's very early days. Does that necessarily inform a change in strategy or allocation of capital from an HSBC perspective? Definitively not. We have, I think it would be fair to say, the kind of access that we seek in terms of – when I say that I mean market access in mainland China now. You obviously have seen, until fairly recently I would say, a flurry of announcements about things that other banks or insurance companies or broker dealers would like to do in that space. To the extent that those institutions have been American, perhaps there's been a slight cooling of ardour in that regard over the course of the last month or two.

Notwithstanding a regulatory construct, which would suggest an opening up of the economy, as Kathleen can attest there is still a fairly extensive range of approval processes that one needs to go through, that takes a not-insignificant amount of time, before an enterprise is actually able to open its doors for business. So the policy direction is encouraging, we certainly welcome it. I think we're happy that we're there a little bit earlier than other people in terms of having the opportunity of possibly a couple of years to build presence and scale of business before others will necessarily be able to compete on the same terms. But it certainly doesn't inform a fundamental change in terms of capital allocation strategy for mainland China from an HSBC perspective.

Chris Manners, Barclays

Good morning, it's Chris Manners from Barclays here. A couple of questions, if I may. The first one was on the positive jaws and why this is so important, because this is an adjusted metric and so you have some flex in defining that jaws number, and things like you're saying about hiring this year to get people in ready for Jan 1, starting work. Surely that makes sense, that's going to be positive revenue, and if we really focused on this jaws number we may end up sacrificing future revenue growth, slowing that. Also, as I say, it's an adjusted metric. So if you'd taken out the legacy credit sale, for example in Q2, some of these jaws numbers can actually look better.

Iain Mackay

Yeah, but as you see, we don't do that. We're trying to make the right economic decision, but this is a big, complex place, with 229,000 employees, and if you do not keep discipline around this place it can run away with you. And there is an element here of 'Great plans, fabulous, now build a track record of delivering against the commitments that you make'. And that's a pipeline of commitment that has been built with a lot of effort over the course of the last few years. And my own view is that I agree entirely with John's desire to maintain that discipline in place. And the minute you let up, with 229,000 people operating around the world, it seems to be a license to go and spend money. Can't be allowed. It's just about delivering what you say you're going to do, and if that means it requires a little bit more discipline and tighter project management, about how you hire people, how you manage projects, how you deliver on your commitments, then that is a good outcome.

But in terms of decisions that are economically appropriate, that we are in very direct control around the timing with which we can execute that and we've got a high degree of insight and assurance around what the outcomes are, we will do the right economic decision, focused on the long term. Allowing people to move ahead on operating expense versus a decision like selling legacy assets is slightly different. They both have economic weight attached to each of them. One has got a higher degree of certainty of outcomes, as opposed to the other. And people need to build a track record of delivering against their commitments. And that is improving and has improved significantly over the last years, but that's a discipline that's required to be maintained within the firm.

Chris Manners

Got you. And I guess the second question was on the capital ratio. Previously guided 12 to 13%, we're now saying 14% plus for the planned period. When we look at the rationale for where that 14% comes from, a lot of those things you'd say we knew in January, February, March this year. So I suppose you must be thinking that those, maybe they're temporary, do they ever go away? I'm just trying to think about where –

Iain Mackay

For example?

Chris Manners

I suppose you've got diversification of your business model, and sum of the parts adding up to more than the Group. Presumably you could be more effective with your deployment of double leverage, and you'll be able to – depending what Sam says and the PRA and everything.

Iain McKay

Indeed.

Chris Manners

And when I looked at it, it looked like maybe you could deploy a little bit more. Can we ever see HSBC in this 12 to 13% range, or is the normal capital stack with the MDA and the management buffer not relevant for you anymore?

Iain Mackay

No, it's entirely relevant. But based on what we see in front of us, the management team's view is we need to operate at or above 14%.

But look, our approach to this has been prudent throughout, and I think it would be unfortunate to run at a level of capital up to 2022 that we may – and let's assume that we find out before 2022, but probably not much before 2020 – that we are faced with a capital challenge in front of us. So there is a degree of prudence if you like, conservatism if you will, around using the information we learned from the stress testing, the regulator's response to stress testing, the work that we do in ICAAP, the regulator's response to ICAAP, which by the way has been extremely positive and very helpful and credit to the teams for the progress that we've made in that regard. But everything that we see in front of us in terms of the corporate structure of the Group, what needs to be done and is being done from a recovery and resolution standpoint, multiple point of entry, MREL requirements, common equity tier 1 requirements in terms of building towards Basel III revision, and so on and so forth.

What we know at this point in time, informed by what we've learned over the last nine months, would suggest that we need to be operating somewhere around 14% or a little bit higher. You all did the mathematics; if we execute against the financial plans that we talked about in the investor day back in June, it's likely to be higher than that as we work through 2019 and certainly 2020, as we learn more about Basel III revisions. If we learn more that tells us that the RWA inflation that is suggested by the guidance that was provided at the beginning of December last year is not going to come through, then I suspect the team will give you new capital guidance.

Richard O'Connor

Just on capital allocation, we've made very good progress getting money out of the US, over $5 billion with another $0.5 billion in CCAR at the end of June. We've still got around $5 billion left and that job is going to be ongoing, just over $1.5 billion in the United States and bits and pieces elsewhere, so the team is highly focused on this but it's going to be an ever-ongoing challenge and there will be bits of capital in subsidiaries that we'd like at the Group level. Sometimes there are timing differences there, but we're on it.

David Lock, Deutsche Bank

I've got two, please. First of all, you've been doing your investment spend now for about a year. You've been stepping up the investment spend for about a year.

You talked specifically back then about doing digital investment and particularly in Canada, I think it was at the time.

Iain Mackay

All over the place. Some of the investments we talked about in the second and third and fourth quarter last year were orientated around the Retail Bank, for example, with a focus on a couple of markets just to do simple modification, of which one happened to be Canada.

David Lock

I just wondered if you could talk to specifics about what kind of revenue improvements you've been able to generate from those, so just some specific examples – say Canada, say the digital investment. Can you talk to where those revenues have come through, so we can see the evidence of the benefits of that investment?

I have a second one as well on the investment spend, which is really how are you thinking, as a management team, about how this interacts with impairments. I know we've only had two quarters but, under IFRS 9, it's very volatile. If we do have a sustained period of low impairments, you're obviously going to be looking at the jaws, but you're also going to be looking at profits, so they're going to be better than what you might have expected. At what point do you say, 'Hang on, I'm going to use some of that lower impairments that we have experienced to actually unlock further investment and potentially run with lower jaws, but to drive the revenue growth in the future.'

Iain Mackay

On the second point, I think we talked about this back in June. From an impairment outlook, what we have built into our financial planning informing greater than 11% return on tangible equity by 2020 is normalised-through-the-cycle credit losses, which we talked about as being in the range of 30 to 40 basis points. That is not necessarily a reflection that we see it migrating to that sort of level of credit cost at any point in the near future, but it is an expectation that credit costs need to normalise at some point.

Whether it falls within the timeframe of 2020 or later, no one knows. It would be nice in terms of being able to give you guys greater clarity, but we don't really have insight to that, because probably a few of us would say that we'd have expected higher credit costs to be realised at this stage in the cycle anyway, but we're not seeing that and we're actually seeing incredible stability across portfolios around the world. There are portfolios, or actually there are jurisdictions, which we're, for fairly obvious reasons, watching even more closely than we usually would, the UK for one which hopefully everybody on this call would appreciate why but, within the UK portfolios, again quality is very, very stable.

Clearly if we were to experience lower credit – now, credit costs have no impact on jaws – but where we'd see lower credit costs, then we'd expect, based on the financial planning that underpins strategy, to see better returns, but we've assumed that we've got some normalisation and I think that's a prudent assumption to retain in terms of longer-term planning.

In terms of the impact of IFRS 9, we've actually seen no volatility up to this point. What we've seen come through has been a function of the delinquencies that we're seeing in the portfolio, recoveries that we've seen coming through, for example in oil and gas, as we evidenced last quarter. What we haven't had yet is any significant factors from an economic perspective or a portfolio performance perspective that would inform a significant deterioration in credit quality from the point of origination of that credit quality that would move us from phase 1 to phase 2, from a provisioning perspective. When that happens, assuming it does, then that is the point at which we will start to see – I don't know if it's volatility – but we'll see different behaviour on an accounting basis, emanating from the application of IFRS 9.

Over time, and this actually came out of what we saw coming out of our stress testing for ACS and, as you know, the stress that they applied was essentially the same as 2017, but a desire to incorporate the influence of IFRS 9 and to try to isolate it to try to gauge what would happen under stress. Now, that stress is conducted over a five-year period so, over the five-year period, entirely intuitively, IFRS 9 had very little impact. What it did was it moved more into the early stage of the stress period but, over the five-year period, it actually didn't change the outcome from an overall credit loss perspective to any significant degree, which is broadly what we would expect, but it clearly would have an influence over the timing of recognition of losses.

Moving back to the regulatory discussion, clearly and entirely appropriately in a forward-thinking manner, the PRA as one regulator wants to get some appreciation of how that would impact capital ratios and then what they should do, how they should respond as regulators in that regard. Sorry that's a long-winded answer to your question on IFRS 9, but watch this space.

On digital, one of the things that we are working on with our business finance team is to provide greater connectivity between the information that we can provide to this community around individual investments that we make and the payback that they represent. But let me step back and look at this and how I think we need to continue to look at this. Before we make investments, we need business cases that we have confidence in and confidence emanates from my response that I gave to Chris's question, which is some teams are very good at putting a business case together and delivering against it to the penny or better. Some teams are great at coming up with the ideas and developing a business case and perhaps not having the best of execution. We have a variety. We've got a mix of both with, I'm happy to say, a significant preponderance in the former category as opposed to the latter category, and that is continuing to improve.

When you look at the revenue progression within the Retail Banking and Wealth Management and Commercial Banking businesses, and you correlate that back to investments that we've made over the last four years through the Cost-to-Achieve programmes, ongoing investment within the operating expense base of the firm to upgrade technology, to upgrade process, to improve skills within the organisation overall, yes, there's a component that is informed by interest rate normalisation, but there's also a component that is informed by increasing volumes and improving market share. Perhaps the most outstanding example of that is in Global Liquidity and Cash Management, and Global Trade and Receivables Finance, the former of which has seen significant investment over the last four years. The latter of which, Global Trade and Receivables Financing, will see significant investment over the next couple of years.

If I were to pick out one example, which has been very much about protecting market share and retaining customers and that, thus far, the data would indicate that we have been highly successful, it was a mobile banking app, which is PayMe in Hong Kong. We now have 1 million customers on it, which is an electronic wallet which, in many respects, mimics the capability of Ant Financial and Tencent. It was introduced on a very short cycle basis. It wasn't a big investment from a Retail Banking and Wealth Management perspective. It was implemented quickly, successfully, and we've got 1 million customers up on that now in Hong Kong. Last year – and Kathleen will correct me if I'm wrong – I think it was the number one downloaded app in financial services in Hong Kong, last year, which would certainly jibe with the fact that we've now got 1 million customers on it.

Has that directly translated into higher revenues? I'll ask Kathleen. I'm not sure it has, but it's definitely protected market share in Hong Kong and provided a facility that otherwise customers would have gone to Tencent or Alipay to get.

Richard O'Connor

Let me give you an example in Canada in Retail Banking and Wealth Management. We spent a lot of money and it was a pretty flat franchise for a number of years. Early days, but first-half loans were up about 10% and revenue 9% in RBWM. We still invest in that business, so profits were stable, because we're still spending money, but we are seeing good growth in the franchise in Canada, as a result of that investment and marketing and mortgage campaigns, and that sort of thing.

Guy Stebbings, Exane BNP Paribas

Coming back to capital, I appreciate all the comments you made that there is some uncertainty around the finalisation of Basel and other items but, in terms of managing the business, to what extent are you already putting in best-guess estimates, when you're then pricing or allocating capital? It is changing things already?

Iain Mackay

No, we price based on thresholds set in terms of returns for return on tangible equity and that is informed, at a first pass, by the basis of regulatory capital requirements at a Group level, but also, where those regulatory requirements are significantly different in markets, that is refined to reflect local regulatory capital requirements. It is to optimise returns in terms of how we price and deliver product in the local market, on a basis that is equivalent to those competitors in the local market, which is local regulation.

Our book is not a long-dated book. The average tenor on our book is around 36 months. There's some stuff that goes out a bit longer. There's quite a lot that sits a lot shorter. The ability to make predictions about what the potential capital outcomes will be three years from now is not how we're influencing pricing in the marketplace today. It is informed around current pricing dynamics, with a focus on generating and improving returns against tangible equity deployed in that marketplace. That is an individual legal entity view, at an aggregated global business view, so we have returns on tangible equity targets set for each of the businesses and established within each of the main operating entities. That is recognition of the fact that we've got to try to deliver returns against the capital that is informed by regulation at a Group level, but how we operationalise that needs to be consistent with market behaviour in each of the local markets. For example, in the United States, where possibly the regulatory construct is most different from the PRA, the basis on which we have developed thresholds on pricing is informed by US regulation.

Guy Stebbings

Just coming back, in terms of longer-dated maturities, say a five-year fixed mortgage, which will probably run beyond things like changing PRA mortgage risk weights, getting close to the potential Basel floor impacts and things like that, presumably you have to begin to factor in some of the regulation.

Iain Mackay

Yes, so there is some sensitivity around those products that have a longer tenor, where we have, shall I say, greater levels of understanding as to what the final outcomes may be.

Guy Stebbings

On a different tack, litigation conduct, obviously you made good progress in recent periods there, but have still got, I think, $3 billion of provisions outstanding. You've hopefully got a pretty good sense of how PPI might evolve in terms of timing there but, on some of the other larger items, are you able to give us any update on hopeful timings of when they might be settled?

Iain Mackay

Note 12, interim report – that's the best I can give you. That note and everything that's in it is the subject of a great deal of review, dialogue, debate between legal counsel and the Finance team and the Risk team, and it is informed by a detailed assessment against each case that's undertaken by Legal, supported by external legal counsel, which informs to a significant degree, obviously, our strategy in terms of how we deal with each case, but also how we view the requirements for provisioning in the context of planning accounting guidance, in that regard.

What is important is that one of the biggest cases that was outstanding in that pipeline, the FIRREA case, is that we've reached an agreement in principle around that with the Department of Justice for a settlement of $765 million. When you compare that across the industry, it's probably a bit lower than many of those that have already settled. Part of that is informed by the fact that we were, relative to others, quite a small player in that marketplace, leading up to the financial crisis. Part of it is, again each case, I'm sure, was settled based on the specific facts and circumstances of each case, but that was one of the big ones that is very good to get out of the way. Others that the team is working to try to get cleared out over the course of the coming months, which are significant, are noted in Note 12, which are the tax cases with regard to Belgium and Switzerland, on both of which we're making good progress. As to exactly when we reach a final outcome, with the DoJ or in the case of Switzerland and the Belgian tax authorities in the other cases, is always subject to how the discussions go.

Richard O'Connor

To unpack this a bit more, we have a slide in the fixed income deck on it. That one is basically PPI. We'd expect to spend that over the next 15 months. The $2 billion clearly includes the mortgage securitisation case, which we hopefully expect to pay. On the tax-related stuff, that's $630 million of the remaining $1.3 billion, so you can see where we're whittling down that $3 billion steadily over time.

Iain Mackay

In terms of what's coming in the top of the funnel and what's going out at the bottom, frankly and thankfully, the flow has slowed considerably.

Alastair Ryan

Two for me. Global Trade and Receivables Finance hasn't been growing in the last 12 months. Investment, is that to bring the cost of provision down or is that because you think you could take market share?

Iain Mackay

Well, we have taken market share to basically hold numbers where they are. They've been fairly flat, to your point, Alastair, for probably the last two and a half years. They've been held flat because we've been taking market share. Part of that is because certainly European banks that were operating in markets like Asia and the Middle East have retrenched, to a certain extent. The investment that we are making over the course of 2018, 2019 and 2020 is very much around the modernisation of the platform. You'll have seen coverage in the press about various banks, including HSBC, executing trade and receivables finance transactions on distributed ledger technology. That is true, but the number of transactions that have been undertaken is tiny and I don't mean just for us; I mean for the entire industry. It's not a particularly complex business, but there are no real standards that govern this on a global scale.

If we take the couple of transactions we've done, we had to get the supplier and the customer lined up in terms of agreeing standard terms of, if you like, execution. We had to get the supplier bank and the customer bank, which in this case was ourselves, and any third-party correspondent banks involved in this to agree the way in which it's done. The fact that we get a few transactions done is great, because it's a bit like building momentum in this, but it will be quite a long time before distributed ledger technology necessarily is the platform of choice for settling trade and receivables financing transactions.

When we look at our platforms, what is an intensely manual business still, there is both a need and an opportunity to modernise that platform in terms of continuing to provide, frankly, an appropriate and easy level of service for our customers. There will be – and I'm sure John and Noel will talk about it in more detail in 2019 – but there will be quite significant investment going into that platform over the next couple of years.

Alastair Ryan

Thank you. The second one is on page 20 of the interim report. A very helpful breakdown you give us – some of the banks don't – on interest income and interest expense. The yield on your cash has stayed very low. Why is that? Shouldn't it be going up as policy rates are going up? I know, behind that, there are 101 different things going into it. The yield on your loans has been moving like we'd expect and that's the one that's stopped a greater improvement in interest income.

Richard O'Connor

I think there's been a shift from US dollar to sterling, because obviously we had liquidity in the United States that has now been paid back and we've put liquidity back into the UK for ring-fencing.

Iain Mackay

That's part of it, certainly.

Richard O'Connor

That's most of the reason.

Alastair Ryan

In which case that ought to improve as UK rates move up.

Iain Mackay

The movement of the Bank of England last week will help in the second half of the year for the UK banks, definitely. Other questions, Hong Kong, here in London? Looks like we've got one in Hong Kong.

Yafei Tian, Citi

One question on the Wealth business: just looking at the slides of distribution of Wealth, particularly on the insurance side, I understand that in the Asia investor update this has been a growth driver or appears to be a growth driver for revenue in the region and at the Group level. Recently, we have seen some slow growth. Maybe it's because of the market, because of the trading environment. What are the key drivers when we think about the future growth outlook for the insurance business?

Iain Mackay

Certainly in terms of the second quarter, seasonality was the main factor. We had a very strong quarter in terms of Wealth Management products in the round, including in insurance, again largely informed – not entirely but largely informed – by the Hong Kong market in 1Q18. 2Q18 was slightly slower, still progressing over the second quarter of last year, but a little bit slower than the first quarter of this year. That was largely informed by seasonality, because we've seen a similar trend in other years.

In terms of what informs the key drivers of growing revenues in this regard, I suspect you know the answer better than I do: confidence in Hong Kong. It can move very quickly. The US President's rhetoric and the debate with China probably doesn't necessarily help a great deal, in terms of maintaining the levels of confidence in investment, broadly speaking, that we've seen in Hong Kong, mainland China and the wider Asia. It's something that we're watching very closely. Part of it is clearly distribution capability. This is an area where Charlie Nunn and the Retail Banking and Wealth Management business have continued to bring in front-line associates to support advisory work for our customers and revenues in that regard. When you look at investment, it's not just about technology; it is about continuing to put front-line associates in front of our customers who can help them inform their decisions, in this regard. I think clearly some of those investments, when it comes down to it, in terms of moving revenues forward in this regard, the general level of confidence of our customers in the markets around the world will be one of the key determinants in this.

Richard O'Connor

We continue to gain market share. In Q2 we took market share again. For the last four quarters we've done that, and were number one in Hong Kong in Q2.

Yafei Tian, Citi

Just to follow up on that question and thinking about connectivity between Hong Kong and mainland China, are there many of these growths, in terms of manufacturing underwriting, bought by mainland customers?

Iain Mackay

Kathleen, you can provide more detail on this – what we've not done is cross-border sales. We have provided products to customers in Hong Kong who have a relationship with us in Hong Kong. We have provided product to customers in mainland China who we have a relationship with in mainland China, but what we have not done is cross-border sale of insurance products.

Kathleen Gan

That's right. In fact, that's what makes us quite sustainable, because a lot of the insurance companies actually try to sell insurance giving the credit cards, UnionPay for example. We never went into that. We're very, I guess, quite disciplined in terms of how we transact and that has helped us as well. A lot of the other insurance companies actually started dropping market share when that was not allowed by the regulators. In fact, actually, if you put market conditions, volatility, aside our Value of New Business of our insurance business has grown very strongly. That's probably a better measurement than just looking at the P&L of insurance. If you look at our insurance business in mainland China, it's also grown very strongly. Yes, in Q2 we saw a little bit of a slowdown in growth of Wealth Management but, overall, if you look the first half, Wealth Management across Asia is still growing at a rate of something like 19% to 20%, so that's very, very strong.

Yafei Tian, Citi

Thank you, that's super-clear.

Iain Mackay

Thanks, Kathleen. Thank you. Time for one more and then we definitely need to stop. Last question.

Jenny Cook, Mediobanca

I just had one. I was just wondering, on those costs that you're able to scale back in order to achieve positive jaws for the year, to what extent are those costs postponed? Maybe on 1 January you'll press 'go' on that. I guess I was trying to get a sense of, absent seasonal revenue fluctuations, if I looked at the accounts on a January-to-January basis, rather than in December to December, those jaws may be wouldn't be quite so positive.

Iain Mackay

It's called prioritisation. Where we've got key projects, it goes back to the answer to Chris's question. If the project has the kind of bearing on the long-term economics of the firm, then it's one of those projects that we wouldn't reprioritise or postpone. If it's a project that we feel we have propensity to maintain momentum and slow down the rate of expenditure, such that we deliver against our commitments, it's part of discipline. It's what it is. As long as we deliver positive jaws for the year in which we're reporting.

You know, you can sit and have a debate about targeting the cost-efficiency ratio; is that better than positive jaws? Take your pick. It's a measure to maintain discipline around operating leverage, pure and simple. That's it.

Richard O'Connor

I'll just add to that. This year, we came into this year and we went from CTA of $3 billion to nothing. That's always going to be a bumpy landing in the first couple of quarters. We only started off from next year, but next year we're obviously thinking of a more even spread of cost and revenue, but that's early thinking at this stage of the year.

Iain Mackay

Thanks very much, everybody, for your time this morning, this afternoon in Hong Kong.

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.