Transcript

Analyst and Investor Call

1H18 Results Announcement

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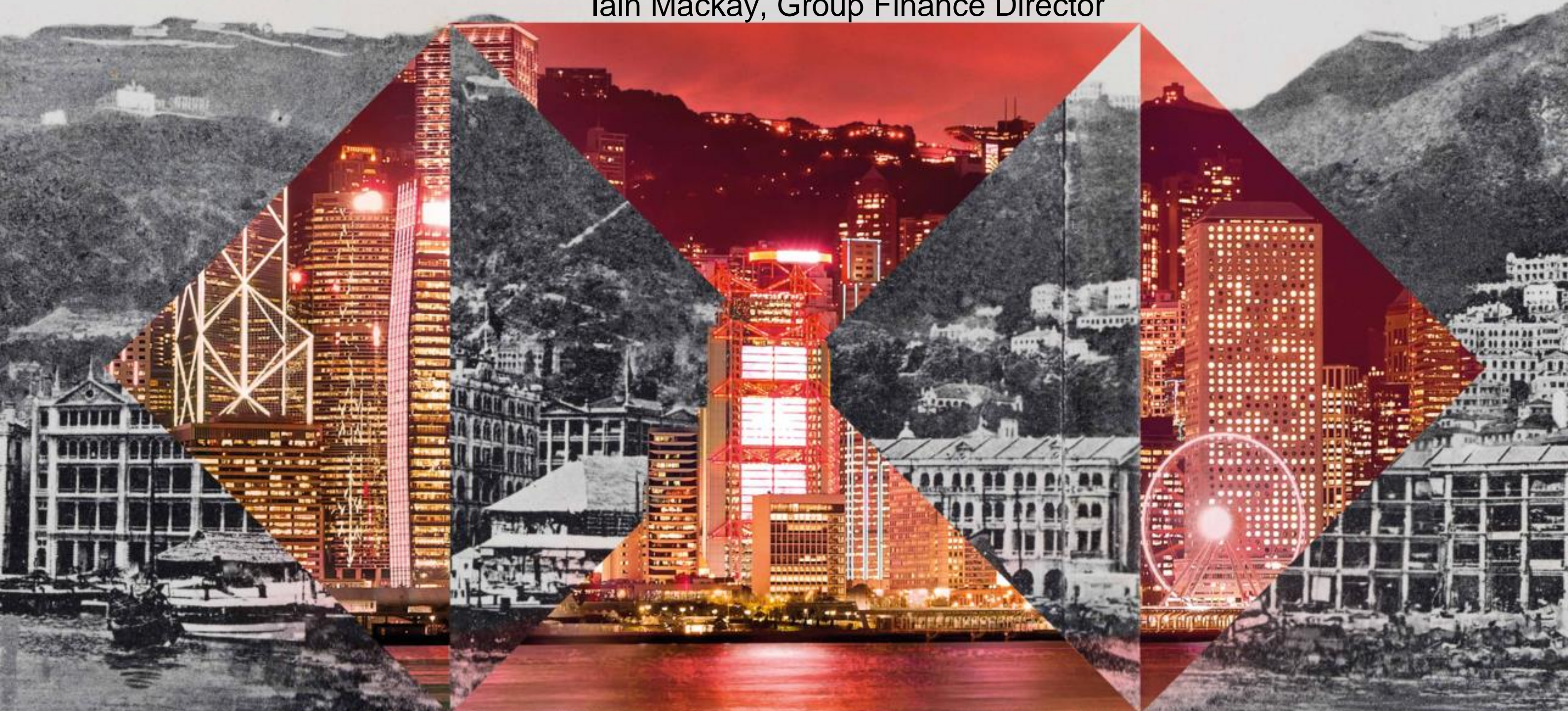
Corporate participants

John Flint, Group Chief Executive

Iain Mackay, Group Finance Director



HSBC

John Flint, Group Chief Executive

Good morning from London, good afternoon to everyone in Hong Kong, and welcome to our 2018 interim results call. I'm here today with Iain Mackay and I'll pass over to him shortly. Let me start though by recapping our strategy and covering the main points of our results.
In June we set out eight strategic priorities that will enable us to grow our profits on a consistent basis and create value for shareholders. In particular, we aim to deliver a return on tangible equity of more than 11 per cent by the end of 2020.To do this, we intend to deliver growth from areas of strength; to turn around low-performing businesses; to invest in revenue growth and the future of the business; and to simplify the organisation and invest in future skills. Central to this is our ability to use the revenue capacity of the Group to invest in growth and competitiveness, within a constraint of full year positive jaws.
For the first half of the year, reported profit before tax was up 5 per cent compared with the same period last year, and adjusted PBT was down by 2 per cent, due to increased investment in the business.
For the second quarter, reported profit before tax was up 13 per cent, and adjusted profits were broadly in line with last year's second quarter. This performance was in line with our expectations.
Our global businesses delivered an increase in adjusted revenue of 7 per cent in Q2. This was offset by the Corporate Centre, which was down against a strong second quarter of 2017.
In line with the guidance we issued in May, our second quarter adjusted costs rose by 7 per cent and were stable compared with the first quarter.
We grew lending by a further 3 per cent compared with the first quarter, and 5 per cent from the start of the year.
Our common equity tier one ratio remains strong at 14.2 per cent. This includes the impact of foreign currency movements and the full amount of the 2 billion dollar share buy-back that we announced in May.

Iain will talk you through the numbers.

Iain Mackay, Group Finance Director

Thanks John. Looking quickly at some key metrics for the first half: The return on average ordinary shareholders' equity was 8.7 per cent; The return on average tangible equity was 9.7 per cent; We had a lower tangible net asset value per ordinary share of 7 dollars, driven by foreign exchange movements; and we had negative jaws of 5.6 per cent due to increased investment in the business. We remain committed to achieving positive jaws for the full year.

Slide 4 provides detail on the items that take us from reported to adjusted. You'll note that there are no "costs-to-achieve" this year. The other main difference in the first half related to legal settlements and provisions. In July we reached an agreement-in-principle with the US Department of Justice to resolve its FIRREA investigation into HSBC's historical origination and securitisation of residential mortgage-backed securities. This amount was substantially covered by the provision we made in the first quarter, as covered on page 105 of the Interim Report. You'll find more details in the appendix. The remainder of the presentation focuses on adjusted numbers.

Slide 5 breaks down adjusted profit for the first half by global business and geography. Profits in our four global businesses rose by a total of 851 million dollars. By contrast, Corporate Centre PBT fell by 1.1 billion dollars due to lower revenue. In Asia, excellent performances from Retail Banking and Wealth Management and Commercial Banking contributed to a strong PBT performance. Europe bore much of the impact of the fall in Corporate Centre, and was also affected by a drop in revenue in Global Markets.

The drop in Corporate Centre revenue comprised: 241 million dollars of valuation differences on long-term debt and associated swaps, which would broadly reverse if held to maturity; A 242 million dollar fall in Balance Sheet Management revenue; A 169 million dollar movement in losses on the disposal of legacy assets; and 114 million dollars of additional interest expenses, primarily due to MREL issuance

Slide 6 looks at profit before tax for the second quarter, which was broadly stable compared with the same period last year. PBT was up in all four global businesses, and up significantly in Asia, North America and Latin America. The drivers of the increase in Asia were broadly the same as for the half year.

In North America, revenue increases and ECL releases related to the oil and gas sector contributed to a large increase in profits. In Latin America, the increase in PBT was driven by a good all-round performance from our global businesses in Mexico.

Corporate Centre was again the main driver of the fall in Europe, due largely to a 632 million dollar fall in revenue. The drivers of this movement were again very similar to the half-year.

Slide 7 shows the revenue trends in our global businesses. Second quarter revenue from our four global businesses was 865 million dollars, or 7 per cent, higher than the same period last year. I'll go through each business in more detail over the next few slides.

Slide 8 looks at Retail Banking and Wealth Management revenue, which grew by 326 million dollars, or 6 per cent, compared with last year's second quarter. We also made market share gains, particularly in the UK mortgage market. Higher balances and higher interest rates drove a 472 million dollar increase in deposit revenues, particularly in Hong Kong and the UK. Income from investment distribution increased by 57 million dollars, reflecting higher sales of retail securities and mutual funds, mainly in Hong Kong.

Lending revenue fell by 83 million dollars due to asset margin compression from competition in the mortgage market. We continued to grow lending quarter-on-quarter and year-on-year. Customer lending rose by 8 per cent, and customer accounts increased by 3 per cent compared with the same period last year.

As slide 9 shows, Commercial Banking revenue grew by 466 million dollars, or 14 per cent. Growth in Commercial Banking is increasingly broad-based, with good performances from Credit & Lending and Global Trade & Receivables Finance, in addition to another excellent quarter from Global Liquidity & Cash Management.

Global Liquidity & Cash Management revenue grew by 22 per cent on the back of increased balances and the impact of wider spreads in Asia. Credit and Lending revenue grew by 6 per cent due to balance sheet growth in the UK and Hong Kong. Global Trade & Receivables Finance revenue rose by 4 per cent as we grew balances in Hong Kong and the UK. Commercial Banking grew lending by 3 per cent in the second quarter, and by 8 per cent compared with last year's second quarter, mainly in Asia and the UK.

Global Banking and Markets revenue grew by 65 million dollars, or 2 per cent, compared with last year's second quarter. After credit, funding and valuation adjustments, revenue was broadly stable. We saw continued positive momentum in key product areas, including double-digit percentage revenue growth in Global Liquidity & Cash Management, Securities Services and Foreign Exchange. Global Banking revenue was broadly stable, as the impact of growth in lending balances and market share in Debt Capital Markets was offset by lower corporate issuances and tighter margins. Global Markets revenue was down by 13 per cent against a strong second quarter of 2017, due mainly to lower client activity in Rates and Credit. Adjusted RWAs fell by 11 billion dollars in Global Banking and Markets in the second quarter.

Global Private Banking revenue grew by 2 per cent compared with last year's second quarter, supported by positive net new inflows

Corporate Centre was a major factor in our second quarter performance. As noted earlier, a significant portion of the reduction in revenue arose from valuation differences on long-term debt and associated swaps, on which we expect ongoing volatility from quarter-to-quarter. These differences would broadly reverse if held to maturity. We continue to manage down our Legacy Credit positions. In the first half we realised a loss on one specific transaction that was capital accretive. With respect to Balance Sheet Management, full-year revenue guidance remains broadly unchanged at 2.3 to 2.5 billion dollars. Interest expenses are expected to stay at broadly the current level for the rest of the year. We remain focussed on improving capital efficiency in Corporate Centre.

Net interest income largely reflected higher deposit margins in the second quarter, rising 4 per cent to 7.6 billion dollars. As we worked through the quarterly NII and NIM trends we identified a few possible minor adjustments to the Q1 NIM number which, if made, would confirm continued quarterly progression. NIM in Asia rose by 15 basis points from the full year to 2.03 per cent, due to higher deposit margins.

By contrast, Europe NIM fell by 17 basis points to 1.18 per cent due to asset margin compression, and the higher cost of funding and liquidity in the non-ring-fenced bank. The higher funding and liquidity balances and their impact on NIM reflected management of the implementation of ring-fencing as at 1 July. Group net interest margin for the first half was 1.66 per cent, 3 basis points higher than for 2017.

Competition for good quality lending remains strong, balanced by higher yields on surplus liquidity. We anticipate further progress on net interest margin and net interest income as we continue to grow the business and as monetary policy normalises. In the first half alone we grew lending by 5 per cent. There is more detailed information on NIM in the appendix.

Slide 14 looks at expected credit losses and loan impairment charges. The second quarter benefited from a release in the oil and gas sector in North America. The credit environment remains stable and expected credit losses remain unusually low. Bear in mind that expected credit losses are very sensitive to any changes in forward economic forecasts under IFRS 9.

Slide 15 shows our operating expenses for the quarter. These were 554 million dollars, or 7 per cent, higher than the same period last year, and broadly stable compared with this year's first quarter. Unlike in the last few years, there is no CTA programme in the strategic plan – so we have to create the capacity to invest more through a combination of cost discipline and revenue growth. To that end, 300 million dollars of cost savings helped absorb the additional cost of inflation, regulatory programmes and compliance in the second quarter.

We invested an additional 400 million dollars in growth, digital and productivity in Q2. In Retail Banking and Wealth Management, we are investing in our Cards businesses in the US and the UK, and in marketing, front-line sales and technology in the US, UK and Pearl River Delta.

In Global Banking and Markets, we made further strategic hires in Global Banking and in Global Liquidity & Cash Management, and continued to invest in our securities joint-venture in mainland China.

In Commercial Banking, we are hiring more relationship managers to win new business in Hong Kong and mainland China, and updating our core systems in Global Liquidity & Cash Management, trade finance, and business banking in Hong Kong and the UK.

We will continue to invest in the business subject to growth in revenue, and expect full year costs excluding the bank levy to be as previously guided. Turning to capital, the Group's Common Equity Tier 1 ratio on 30 June was 14.2 per cent. Our Common Equity Tier One capital reduced by 6.8 billion dollars in the quarter. Capital generation of 1.9 billion dollars was more than offset by foreign currency movements related to the strong US dollar; and also the recent share buy-back, the full impact of which is deducted from capital. Risk-weighted assets grew by 1 per cent on an adjusted basis in the first half, compared with loan growth of 5 per cent.

Slide 17 looks at our Group return metrics. The return on tangible shareholders' equity was 9.7 per cent, or 11.5 per cent excluding significant items and the bank levy. Our reported revenue as a percentage of RWAs rose by around 20 basis points to 6.3 per cent compared with last year's first half. We continued to benefit from low expected credit losses in the second quarter. Our four main global businesses each achieved returns on tangible equity above the Group's cost of equity.

We are investing to grow these businesses, and to improve the Group's return on tangible equity to above 11 per cent by 2020.

I'll now hand back to John.

John Flint

Iain, thank you. Our global businesses have now delivered eight successive quarters of year-on-year revenue growth and carry momentum into the second half of the year. On this basis, we remain confident of achieving

positive jaws for the full year. Our main focus is on delivering a return on tangible equity greater than 11 per cent by 2020. We're a well-funded business with strong capital generation and a diversified balance sheet, and we are investing to grow revenue further and strengthen our competitive position. We remain cautiously optimistic about economic conditions for the remainder of 2018. We shall now take questions. The operator will explain the procedure and introduce the first question.

Ronit Ghose, Citigroup

It's Ronit from Citi. First of all, a quick question on margin: you've given us some comments around the Europe decline first half versus last year, 17 basis points down. Iain, I don't know if you can give us some more colour on the quarter-on-quarter NIM trend and specifically any colour around how much this is driven by the NRFB formation. That seems to have a big delta when I looked at what happened to NII and NIM in the quarter, so that would be really helpful.

My second question is about jaws, and this is for either of you. In the second quarter, we've obviously got underlying about six-percentage-point negative jaws. Costs underlying come to about 16.4 billion dollars for the first half. Are you looking at, implicitly or explicitly, flat costs half-on-half ex the levy? I'm just trying to work out how we get to positive jaws for the year, because it's looking quite challenging.

Iain Mackay

Thanks, Ronit. Quarter on quarter from a net interest margin perspective, broadly stable. The features that are driving that remain pretty much consistent with what we've talked about in the past. We continue to see good development across net interest margin in Asia, and our comments and the analysis on that point do bear that out. Specifically in the UK and formation of the non-ring-fenced bank or, actually, the formation of the ring-fenced bank and, by definition, the non-ring-fenced bank, if you reflect on HBEU, we've maintained a strong funding and liquidity position within that legal entity, consistently. As we created the ring-fenced bank, the strength of the customer deposits sitting within the Retail Bank and the Commercial Bank principally become part of the ring-fenced bank and are no longer available, in terms of funding and liquidity sources, to the non-ring-fenced bank.

As the industry approached ring-fencing, the PRA set out some specific requirements with respect to LCR and net stable funding ratio. To ensure that we achieved those positions by 1 July with a margin of safety, we strengthened the funding and liquidity position within the non-ring-fenced bank over the first half of the year and, most notably, within the second quarter of this year, leading up to 1 July. We had LCR and NSFR ratios somewhat in excess, in fact well in excess, of requirements from a regulatory perspective and, as we move through the remainder of this year, we'll optimise that balance sheet and hit the right position, but we wanted to make sure that we had a strongly funded position over the transition period into the non-ring-fenced bank. For clarity, just for memory's sake, the non-ring-fenced bank essentially contains Global Banking and Markets and then other activities that are not permitted to be within the ring-fenced bank.

Raising that extra funding and ensuring a strong liquidity position had an adverse impact on net interest margin in the second quarter of the year but, overall, net interest margin continues to progress half-year on half-year. We saw 1.63 per cent in 2017 and 1.66 per cent for the first half of 2018. The key drivers of that are the continued normalisation of monetary policy, notably in the US dollar and related currencies, and that translating through the deposit surplus, again most notably within Asia but more broadly. What we are beginning to see is some stability in asset pricing certainly in the Asian market. Although, as we comment today, it continues to be fairly competitive in mortgage pricing, both within the Hong Kong and the UK markets. John, I don't know if on jaws you wanted to take that question.

John Flint

Sure, Iain. Thank you. On jaws, the first thing to say is our results at this stage in the year are in line with our expectations, so we are where we thought we would be. The money that we've spent is in line with our plan, and we guided that we expect costs ex the bank levy to be reasonably stable, half on half, so that does mathematically get you to a stronger revenue growth number for the second half of the year. The way that I think you should think about that is as follows.

We've had good balance sheet growth in the first half of the year and we've enjoyed continued progression with net interest margin, albeit modest progression. As monetary policy continues to normalise that will continue, so we should enjoy momentum on the net interest income line heading into the second half of the year. It's also the case that there were some aspects of the Corporate Centre performance in the first half that we might reasonably expect not to repeat themselves in the second half, so our business plans do see us get to positive jaws by the end of the year, and we remain reasonably confident about the revenue outlook that will get us there.

Ronit Ghose

Thanks for that, John. Iain, can I just jump back to your answer to the margin question? Can you quantify or help me understand exactly how much structural change or NRFB formation contributed to it as a headwind for the margin, Q-on-Q? Maybe another way to think about it is, when you're looking ahead into the second half, is this the steady state for the UK/European business or do we get anything back? Any colour around that would be great.

Iain Mackay

We will certainly see higher funding and liquidity costs in the non-ring-fenced bank compared to history. What we would expect as we go through the second half of the year is that we will fine-tune our funding and liquidity requirements within the non-ring-fenced bank going forward. In terms of the impact to net interest income in the first half of the year as we built that funding and liquidity position, it was somewhere in the region of 100 million dollars in nominal terms. We did come into the creation, on 1 July, with a strong funding and liquidity position somewhat in excess of the regulatory guidance. We'll normalise that out and get to a steady state. When we look at this at the end of the year, I would certainly anticipate that you'll have a much clearer view of how that's likely to run from an overall funding and liquidity perspective, going forward.

Ronit Ghose

Great, thanks for that.

Chris Manners, Barclays

Just a couple of questions, if I may. The first one was on the impairment charge. It looks very low in the quarter. Obviously you flagged a write-back there. Could you maybe just help us a little bit with the outlook? Are there any parts of the loan book that you're worried about at all? Maybe you could help us think about how you get to your 11 per cent plus RoTE target, what sort of cost-of-risk numbers you're thinking about in there?

The second question was maybe to come back on the European NII point. Obviously we've had the UK rate hike now. How much of a benefit do you think that might be to your net interest income in the UK business, and how are you thinking about passing some of that rate hike back to savers?

Iain Mackay

On that last point around the impact of 25 basis points on the Bank Rate at the end of last week, over the remainder of the year, we would expect to see an uptick of some 40 million dollar positive impact to net interest income.

In terms of talking about impairments longer term, Chris, at the investor update on 11 June we talked about our greater-than-11 per cent return on tangible equity target reflecting what we believe to be normalised credit cost, in the range of 30 to 40 basis points. To be clear, that target of return on tangible equity is informed by a higher expected credit loss and loan impairment charges than we are presently experiencing. In terms of any specific portfolios that are cause for concern right now, that's not the case. We are seeing very stable credit costs at a low level as we comment today. Areas where we've previously commented that we're keeping a pretty close look, not because there are emerging issues but because the operating conditions would suggest that there may be emerging issues. For example, the UK high street and retail more broadly is one of the areas where our credit teams are keeping a very close watch on things. Whether it's in the United Kingdom, further afield in Europe, Asia, the Middle East or the Americas, certainly the credit outlook at the moment is fairly stable.

Chris Manners

Thank you, and could I follow up on that 40 million dollars of extra NII that you're expecting? What sort of pass-through rate would that mean on your savings accounts?

Iain Mackay

The depositor beta, certainly in markets where there's fairly significant competition for deposits, is beginning to move up. In the UK ring-fenced bank, we have a very, very healthy funding surplus and, as a consequence of that, our depositor beta is going to be informed by the overall strength of the funding position in the United Kingdom. That's probably the extent of what we would say at this point, Chris.

John Flint

One thing to add of course is, now that we've actually ring-fenced, the management of the ring-fenced bank are the ones who are taking the decisions on pass-throughs and savings pricing, etc. It's a great time to get the question, but you're in a slightly different world now.

Chris Manners

You would debate that with them, surely.

Iain Mackay

We would indeed, of course.

Chris Manners

Thanks.

Joseph Dickerson, Jefferies International

It's just going back a bit to the first question. Could you discuss your outlook for cost growth in the second half of the year? I know you've said that you would seek to generate positive jaws, subject to revenue growth being there, but what type of cost growth would you expect in the second half of the year? I know costs picked up in the second half of last year, but it seems to me that you'd have to have flat cost growth at some point in the second half, if consensus revenue expectations are correct. Just on the revenue point, given that the Corporate Centre in Q217 was quite a large result, can we expect over the remainder of the year, perhaps, that the revenue growth starts to converge towards that 7 per cent growth you've seen in global businesses? Thanks.

Iain Mackay

Joe, on cost growth, within the second half of last year. We started to phase in some investments that we were particularly focused on trying to get ahead of, in terms of exactly the areas we're investing in for growth of the business now. That informed the somewhat higher costs in the second half of last year. As John mentioned a little bit earlier, we would expect costs in the second half of this year to be broadly consistent, ex the bank levy I should say, with what we've seen in the first half and, again, that would be consistent with what we talked back in May for the first-quarter results. The cost discipline within the firm is enormously important, in terms of informing achieving positive jaws by the end of the year. We have got good revenue momentum and balance sheet build coming through the first half and taking us into the second half of the year.

In terms of the Corporate Centre, one of the key features of the Corporate Centre in the second quarter of last year was valuation differences coming through holding company debt and hedging derivatives on that position. What we do see is some volatility within the overall funding position but, as we hold those bonds generally to maturity, we'd expect that to come back to zero. It is very much around a valuation difference, as opposed to a fundamental economic driver or a cash driver within the business.

From a Balance Sheet Management perspective, the guidance remains very much consistent. When you think about what's in the Corporate Centre, we've got our Balance Sheet Management, so corporate treasury positions, sitting there. We've got our investments in associates, principally BoCom and Saudi British Bank.

That's certainly what makes up the lion's share of risk-weighted assets and capital sitting within the Corporate Centre, and then revenue generators and Balance Sheet Management. We've got the interest expense in the holding company debt and MREL, and again we've guided to that being broadly consistent second half over first half. We continue to run down legacy in a capital-accretive fashion, notwithstanding some disposal losses in card and disposals in the first half of this year, and we're down to a very small number of RWAs. We're down to about 6 billion dollars of RWAs around Legacy Credit now in Corporate Centre. Yes, we would expect Corporate Centre to be more neutral in the second half of the year, allowing for some possible volatility in those valuation differences in holding company debt and derivatives.

Joseph Dickerson

Thanks, Iain. That's helpful.

Raul Sinha, JP Morgan

I was wondering if I could have two please, maybe one just to follow up Iain on the liquidity point. If I look at the liquidity coverage ratio at the Group level, I think you disclosed that, at Q1, is 157.5 per cent and Q2 has actually not moved much. It's 158 per cent. Is that right? I guess that probably implies you built up liquidity towards the end of the first quarter. Is that the reason why you've seen some pressure on the margin and should we expect that to go lowering the second half? That's the first one.

Iain Mackay

From a liquidity coverage ratio perspective, overall, broad consistency. We have seen deployment of more of our funding surplus into growing the balance sheet and that is most noted within the Asian market and within Hong Kong. We've seen very, very strong competition for particularly US dollar deposits within the Hong Kong marketplace and that certainly is beginning to influence deposit pricing in that marketplace. Broadly, the dynamics around net interest margin generation remain very consistent in Asia, with the deposit base beginning to continue to show progress in terms of their contributions to net interest income and net interest margin and, as I mentioned earlier, some stability beginning to appear from a pricing perspective for assets in that regard.

The key feature in terms of LCR, and it's virtually negligible at a Group level, but from an LCR and NSFR level, the areas in which we purposefully made movements in the first half, and most notably the second quarter, were to ensure that we had the non-ring-fenced bank, otherwise known as HBEU, in the right position for the non-ring-fenced bank. Rather, the ring-fenced bank creation on 1 July is the derivative of the non-ring-fenced bank.

Raul Sinha

Is that why the rate sensitivity also seems to have come down a little bit, in the US dollar bloc especially?

Iain Mackay

Some of the features there again, we are we are seeing higher competition for US dollar deposits and that is certainly informing pricing in a number of markets. What we also see, and I mentioned this earlier, is absolutely more of that surplus being deployed into assets with our customers. The other feature that we're seeing is, with the increasing interest rate environment, we're beginning to see a switch away from demand deposits into time deposits, and again that influences overall net interest income and net interest margin. As we would absolutely expect, as this rate cycle continues to develop, customer behaviour is beginning to change, informed by higher rates informing where they place their money, in terms of positioning within our balance sheet. These factors coming together are informing progression in net interest margins. We'd expect to continue to see that progress, as John mentioned, but hopefully that provides some clarity around that.

Raul Sinha

On capital, I can see there's a 20-basis-point negative impact from the FX translation move. I'm guessing that's basically sterling and I was wondering if you were planning to do something to hedge yourselves, as we head towards a possible cliff edge around Brexit, or can you actually hedge your capital volatility for a core tier 1 ratio?

Iain Mackay

Indeed we can. From a structural FX perspective, one of the very few currencies that we do hedge structurally is UK Sterling. We do have a number of hedges in position there. We continue to revisit that on a regular basis, based on how the balance sheet is positioned. It is partial. In terms of hedging out the position fully, we continue to reflect on that, but we've got a partial hedge in place at this point in time.

Raul Sinha

Thanks very much.

Manus Costello, Autonomous Research

I had a couple of questions, please. The first one was on RWAs, where again they've grown by much less than the Group assets over the first half. In particular in GB&M, your RWAs are down 4 per cent but the assets are up 10 per cent, I think because of some model changes. My question is: are there any model changes to come over the next few quarters, and are you concerned at all about how aggressive that risk density in GB&M is becoming?

My second question is on BoCom. I wanted to ask whether or not you thought the BoCom capital issuance in the second half of this year or expected in the second half of this year will have any impact on your value in use, because the gap between carrying value and VIU is pretty tight again.

Iain Mackay

On RWA within the second quarter, we had 8 billion dollars of model approvals by the PRA, which contributed to some of the reduction in RWAs within Global Banking and Markets. Coming out of 2017, we had a total of some 20 billion dollars of opportunities for reductions in RWAs from model improvements pending approval by the PRA. We received 8 billion dollars of that in the first half, specifically the second quarter, of this year and, therefore by definition, there is some 12 billion dollars still pending approval.

In terms of the opportunity to improve RWAs through models specifically, we've made a lot of progress in this over the course of the last three years. The opportunity from model improvements, although not negligible, is a much less significant component of overall improvements to capital efficiency within the Global Banking and Markets business. What you will clearly have witnessed over the course of the last couple of years is the business has made significant progress in improving capital efficiency. Whether that's informed by the nature of managing the overall exposure to customers on a customer-by-customer basis and improving returns, again, you see the overall return on tangible equity for the Global Banking and Markets business continues to progress. We see that at about 12.4 per cent in the first half, or rather the second quarter, of 2018, so the business continues to be very sharply focused on capital efficiency. In terms of how much of that will come from model improvements going forward, it would be less an influence overall.

If you think about the risks to RWA intensity within the Global Banking and Markets business, they are almost certainly informed, one, by credit development as the cycle continues to work its way through but, as you see, we continue to have very low expected credit losses. The outlook remains fairly stable for the time being. The other area is regulatory change, the fundamental review of the trading book as a component of Basel IV, but again that would seem to be still some time into the future, notwithstanding the fact that we keep a pretty close eye on that.

Manus, from a BoCom perspective, the impact of their fund raise, which is a convertible bond, to the extent to which that would have any effect on the overall capital position of the shareholding of HSBC, it would only be in the conversion of that bond into equity. The extent to which that would dilute HSBC would be minimal. To the extent we're diluted, then our equity accounting will simply account for a lower percentage of ownership in BoCom as we presently do. We sit at 19.03 per cent. Then, if you like, the mathematics of our equity share flows through market valuation, value in use and carrying value in the balance sheet. The aspect of that per se and only upon conversion is unlikely to be a significant feature of the accounting for BoCom. The valuation in terms of value in use over time expanded very slightly in the second quarter and, as we've talked about in the past, this is something that is valued and revalued on a quarterly basis, based on input from the markets,

input from our colleagues at BoCom, and is subject to a pretty good scrubbing from both our internal teams and our auditors.

John Flint

Manus, it's John. Can I just pick up on one thing? I don't recognise the word 'aggression' in the way that we do our capital planning and our capital management. I certainly think for GB&M we've been very focused on just becoming more efficient. We've been embedding return on tangible equity methodologies across the Group. GB&M, two or three years ago, was quite challenged from a returns perspective, as you well remember. The business has been very disciplined about extracting capital from low-returning portfolios and low-returning segments, and I think efficiency is the right word. I don't recognise aggression. From a regulatory perspective, the regulators are very diligent around everything we do here, so efficiency is the right way to think about this.

Manus Costello

Thank you.

Guy Stebbings, Exane

Morning. I just wanted to circle back on impairments for a couple of questions, the 30 to 40 basis points, including the RoTE guidance, just to get your view on when you expect this to increase. I appreciate that's very difficult, but any colour would be helpful. I seem to remember you suggesting earlier in the year you're prepared to take a little more risk and grow a little more in unsecured in some markets, so how might that fit in?

Secondly on your comments on UK impairments, just to be clear, are you seeing anything here that you weren't expecting? Given your book is really quite prime, does that worry you about the broader market at all? Thanks.

Iain Mackay

The UK answer is the easiest one: no, we're not seeing anything at this point. I think everybody would expect us, given the degree of uncertainty that faces the UK economy at the moment informed by the Brexit discussion, that it merits appropriate diligence across the portfolios. In terms of overall performance, it remains very stable, but everybody is well aware of those sectors that might be most exposed. At this point in time, there's really nothing emerging of concern.

In terms of when we'll see higher credit costs, I hate to say this, but your guess is as good as mine. From a prudence perspective in terms of forward planning and recognising the goal of achieving and delivering a return on tangible equity of greater than 11 per cent, the plan that we built in that was the basis of the update to the market that John provided on 11 June was informed by a higher expected credit loss coming through over the cycle, and that is informed by something in the range of 30 to 40 basis points. When that might emerge, I'm afraid I can't help you.

Guy Stebbings

Fair enough. Thanks.

John Flint

Okay, I think we're now heading towards our last question for the morning.

David Lock, Deutsche Bank

I've got two, please. The first one is on trade wars. I just wondered if you'd seen any change in behaviour from your Asia corporate client base heading into the second half of this year and if there'd perhaps been any pull-forward of any activity or loan growth before the tariff implementation, which perhaps could lead to lower loan growth in the third quarter.

The second question is whether the BSM guidance of 2.3 dollars to 2.5 billion dollars still stands. I saw that BSM was a bit stronger in the second quarter. Thank you.

John Flint

Thanks, David. On trade wars, I think it's fair to say that we haven't yet seen any meaningful impact on our customer base, either in terms of activity or in terms of risk profile. It's too early to know whether there will be an impact. As we think about the trade wars, from my perspective, I'm more concerned about the trade rhetoric damaging investor confidence, investor sentiment and sending markets lower. That could have more of an impact on things like our wealth business but, from a trade perspective to date, there's been no impact and no customer impact.

With respect to balance sheet management, no change in the guidance yet. Q2 was a good quarter, but no change in the guidance that we previously offered for the full year.

David Lock

Thank you. Just coming back on the first question there, you haven't seen a spike in activity around people perhaps positioning themselves just out of conservatism, going into the second half of the year. There hasn't been any activity like that in the second quarter?

John Flint

No, not that I'm aware of. Sorry; we do have one more question, if that's okay.

Claire Kane, Credit Suisse

Good morning. Just a quick follow-up, please, on the costs, just to clarify you're still expecting costs ex the levy to be stable half on half. That would imply about 33.3 billion dollars for the full year including the levy, which is down a bit from the guidance at Q1 of 33.7 billion dollars. Could you clarify that?

Just with that, given the number of these volatile revenue items included in your adjusted jaws definition, how comfortable are you that you may miss these targets, given the number of volatile items that are somewhat out of your control? Do you think you've got enough in there if you continue on this run rate on those volatile items? Thanks.

John Flint

Let me respond to the second part of the question first. Based on the plans we have now, we are confident that we will get to positive full-year jaws. There are a couple of items in there that are non-economic, for example the valuation stuff. If we get to November and we have some big valuation swings, am I going to start to pull cost levers that would damage the franchise or the Group over the remaining two months of the year? No, I wouldn't do that. I will always preserve the health of the organisation over and above some accounting noise. For the rest of the real costs, the real costs that our economic to shareholders, it is our intention to hit the full-year positive jaws targets. The valuation stuff, as you say, is impossible to predict. Given that it's non-economic to shareholders, I don't want to be making management decisions based on something that actually is not that significant.

The first part of your question reflected or related to the numbers. Iain, do you want to just comment on that?

Iain Mackay

Yes, absolutely. The currency movements take the reported numbers down a little bit but, broadly speaking, Claire, the mathematics that you set out are in the right ballpark. The guidance around operating expenses for the remainder of the year remains consistent with what we said back in May and reiterate today. You'd expect the second half of the year, ex the bank levy, to be broadly in line with where we were for the first half of the year.

Claire Kane

Great, thank you. That's very clear.

John Flint

Thank you. Okay, that concludes today's call, everybody. Thank you very much for being up so early to be with us today. Those of you who have yet to celebrate the summer, have a wonderful summer. Thank you.

Forward-looking statements
This presentation and subsequent discussion may contain certain forward looking statements with respect to the financial condition, results of operations and business of the Group. These forward-looking statements represent the Group's expectations or beliefs concerning future events and involve known and unknown risks and uncertainty that could cause actual results, performance or events to differ materially from those expressed or implied in such statements. Additional detailed information concerning important factors that could cause actual results to differ materially is available in the HSBC Holdings plc Annual Report and Accounts 2017. Past performance cannot be relied on as a guide to future performance.

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