2008 Annual Results and rights issue

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Results overview and bonuses

Q. Stephen, we'll get onto the rights issue and the events in the US in a second. But putting that to one side for now, what's your take on the strategic highlights of 2008?

A. (SKG): 2008 was an exceptional year. It's the most turbulent year that we've seen in the financial markets since the War. It's been a situation which has created a savage downturn in the real economy. In these circumstances, I'm proud of the performance of this bank. We've made solid profits. They're down on the previous year, of course. We've shown the benefits of our diversity, our strength of capital, our strength of balance sheet, and our ability to focus on providing good service to our clients.

Q. And Mike, from an operational perspective, what do we need to understand about the way the bank performed in 2008?

A. (MFG): As the Chairman said, this was a unique year, and in a unique situation. We were profitable - I suspect we were one of the most profitable banks in the world in 2008. We had strong performance in many areas. If I just take Global Banking and Markets, for example, profitable against all the odds and all the difficulties, when others were significantly in different directions. So I think that's a great credit to us. Quality assets, properly provided for, and that's still showing a very strong profit.

Our business in Asia - I mean, the rest of Asia with phenomenal growth. Really working our strategy, implementing that strategy and growing our business out of Hong Kong, building out of greater China. Hong Kong itself had weaker results, but 2007 were exceptional results, which were unlikely to be repeated. The Middle East – very strong businesses. There's a little bit of slowing there now, but strong overall in 2008.

And then we come to the UK, which had an exceptionally good year. It didn't have some of the expenses that it had in 2007. It had all the upside in 2008. Remember, we stood back in 2006 and called the top of the UK market, and we withdrew and bunkered down for a difficult time. We came out and assisted the UK mortgage market in the early spring of 2008. When nobody else would lend we lent.

We also assisted in the inter-bank market. We were very confident with ourselves in the UK, and we've demonstrated that with the results we've shown today.

In Latin America, it was an interesting year. Obviously, our business is very linked to North America. It is slowing. But overall the results were strong. There is going to be opportunities to build out more. And, as people are less confident with other banks, they will be confident with HSBC. We're building a niche there.

In Canada we had lower results, but strong results, particularly bearing in mind their interlink with the United States.

So overall, apart from the United States, which was a disappointment to us and continues to be a disappointment – but we'll work through that – overall the results were very solid across all businesses.

Q. But Stephen, after a 62% fall in profit, is it still appropriate to pay cash bonuses?

A. (SKG): Well, it's an 18% fall in profit other than the goodwill write-off in the US. And I think a 18% fall in profit is actually a very good result in the context of these exceptionally difficult times. And that wasn't achieved by chance. It was achieved by a management team and a group of people around the world who have worked extraordinarily hard, actually to make sure that HSBC continues to do good business. On the way through they have, I believe, contributed very importantly to differentiating HSBC from many other banks who have really got themselves in disarray. So I'm proud of what they've achieved, and frankly they deserve reward for it.

Now as far as bonuses are concerned, I'm well aware this is a sensitive issue in current times. At the Board level, none of the executives directors is taking any cash bonus. There are no performance incentive awards being issued at that level. But if I take the management team through the system, around the world, I think they have a right to the bonuses. They have earned it by hard work, successful development of franchises, in very difficult times.

North America business

Q. Mike, even last year you were saying that the US was fundamentally a strong business. And the last time that you and I spoke, you were talking about reducing your exposure in mortgages, in auto finance. Nevertheless, from that position to this, that you're announcing today, is a drastic step. What happened?

A. (MFG): What has actually happened in the last two quarters of 2008 is that the whole home market has slowed so much, to the extent now that very few customers have equity in their homes. We had a large infrastructure in the United States and candidly they were doing a very little amount of business. So what we've announced today is that we will look after the customers we've got there. We've done modifications for around 100,000 customers, making sure they stay in their homes. But at the same time, we're not going to increase our exposure in this sector of the market, and we will work that through and run it off like we did with the mortgages services, which is down from just under US$50bn to around US$27bn today.

Q. But the US is still a loss-making venture and North America your only loss-making geography. You said it would take time to work through. You've made decisions, some drastic decisions there. What exactly is the cost of discontinuing the consumer finance operation? And also, what would it save?

A. (MFG): Well, there's a one-off charge of approximately US$300m to actually run down the network over the coming months. And then there's probably an annual saving of around US$700m going forward. And it's those two figures that are making compelling sense to close it down at this stage. And the systems are all there; all the platform stays there. So there is add value still sitting in the system. And everything will run on a day-to-day basis exactly the same as it was before, but we won't be originating any new business.

Q. And that's a saving of US$700m. But, Stephen, that's dwarfed somewhat by the US$15bn that was paid for the business in 2003, let alone the cash injections and the write-downs there. Do you regret now the bank's decision back then to buy into

the US?

A. (SKG): With the benefit of hindsight, you can say this is an acquisition we wish we hadn't made. And you know HSBC has a reputation for telling things the way they are. And that's what we've done in this case. What we've announced today is the cessation of new business in our consumer lending business in the US. We're drawing a line under the new business. I think that's the right thing to do.

To be very clear, it was a painful decision. It was not one we wanted to arrive at, but it is the right thing to do. We're well aware that this has consequence for people's jobs, and we're determined to ensure that this is carried through in a way that is sensitive to people's needs. We will continue to look after our customers, as Mike was saying, and we will move on. We are not withdrawing from the US. We have, of course, a bank, a New York State based bank, with presence in some other states. We intend to continue to develop our business in what is, after all, the largest economy in the world. We see opportunities, based on the fact that we have an international calling card that gives us real competitive advantage, with corporates, with businesses across the country, with people across the country, who have connections in other parts of the world where we have a strong franchise.

These are things we're going to build on. We're going to continue to develop our business in the United Sates. And I believe that we will work our way forward over the next few years to a business in the US which is really strong and really connected with the rest of the Group's franchise.

Rights issue

Q. Now Stephen there has been some speculation about HSBC going to the market to raise capital. Indeed, that's what's happening today. Exactly what is the strategic thinking behind this?

A. (SKG): The strategic thinking is that we want to remain what we always have been, a company with signature financial strength. We've always sought to have a strong capital base. We believe that these are very turbulent times, there's a lot of volatility around. Basel II is creating a lot of pro-cyclical volatility in banks' capital ratios. A number of our competitors have had to be strengthened by infusions of government money. I guess the market is reacting to that by raising the bar somewhat. And we believe that we should continue to be strongly positioned.

We don't need to do this – we're very clear – but we think it's a good thing to do because it enables us to be absolutely sure that we can deliver to our shareholders good returns through all of whatever happens in a very difficult market, and also to be in a position to explore opportunities which we believe will come over the next year or two or three, as others frankly have to withdraw from parts of the world that are not their heartland, if you will, but which are our natural bases and where we will want to invest.

Q. But given the two announcements today, it could be construed that the capital raising is there to plug the hole in the US.

A. (SKG): Absolutely not. Our ability to develop our business on the basis of our existing Tier 1 ratio, which is 8.3% at year-end, is already very strong. And we know that we have a capital-generating business in the months and years ahead, even without the rights issue. The rights issue will further strengthen our capital for these exceptionally turbulent times when there's a lot volatility around in the market when, as I say, many of our competitors have had to go to governments for capital. We are determined we do not need to do that. And it will also give us the ability to exploit opportunities. It will give us the opportunity to grow our business organically in fast-growing markets where we have a strong franchise, so that we can put on risk-weighted assets, knowing there's the capital support.

It will also give us the opportunity to look at potential acquisitions that make sense strategically for us within the context of our overall strategy, so that we can carry those out and further build our business.

So I think there are a number of good reasons for doing this rights issue. It's fully underwritten and I think it puts us in an extraordinarily strong position in exceptionally difficult times to make sure we go on growing our business in the years ahead.

Q. Stuart, from your perspective, what do you see as the case behind the rights issue?

A. (STG): Well, I think that HSBC has found its competitive strength, and its competitive signature financial strength, somewhat eroded over the course of the last year by actions taken by various governments to inject equity into their own banks and by various governments to insure deposits in their systems.

So two of our enormous strengths, which was a standout capital ratio and a very high equity component of that, and extremely strong funding with an advances to deposits ratio below 100, have somewhat been eroded by those actions and we want to restore that signature financial strength.

Frankly at this point in time we have a very strong balance sheet, we have a very strong capital ratio, we have terrific funding. With the rights issue in place actually our balance sheet is bullet proof.

We are in an environment where the competitive landscape is continuing to morph and change. And therefore we look to do this early in the process, to re-establish the undoubted financial strength of HSBC. And of course it then puts us in a position to actually, as this financial crisis moves through, and the real economies change or the competitive landscape changes, both to grow organically our market share in emerging markets and also to take opportunities that may come about as various of the banks that have had government money injected in them need to exit some of their overseas to their domestic markets networks.

You should also not lose sight of the fact that we're doing a conventional rights issue which deals completely with pre-emption rights and fully respects our existing shareholders, so we feel pretty good about this. We think this puts us in a very strong financial position, and actually secures HSBC to take advantage of the opportunities that will come through in the next couple of years.

Q. You make what sounds like a strong case. But cynics would say that actually – or speculate – that this is all about plugging the hole in the US. What's you're reaction to that?

A. (STG): I can see why you'd ask that question. I can see why cynics would say that. But it's absolutely not. Our forecast for 2009 sees us producing organically driven PBT sufficient to actually deal with any problems we have in North America and indeed cover a dividend. So this is about positioning us for the future. It's absolutely not about filling holes in the United States.

Q. Douglas you are the guardian, as it were, of HSBC's capital strength. How did you size the rights issue and why now? What do you know now that you didn't know last year?

A. (DJF): I think the uncertainty has grown. I think the downturn in the fourth quarter of 2008 was dramatic across all geographies and has continued and the economic outlook has significantly deteriorated.

We've always had signature capital strength. It's been a very important part of our culture. It's been a very important part of our proposition to our customers, being able to support them through all times. And I think market expectations for the level of capital that's necessary, the regulatory regimes that we operate within, and indeed our own conservatism in terms of the amount of capital that's appropriate in a much more uncertain time, suggests that we should add to the top end of our range and take it closer towards 10 per cent in terms of the Tier 1 ratio. And what we're doing is adding capital through this rights issue to bring that Tier 1 ratio closer to the 10 per cent level, which we think now is appropriate in these times.

I think to have the ability to be strong in capital, to take advantage of options that will only be available to stronger banks, to be able to pursue opportunities that come with a competitive strength as others have less capital – all of that said to us we should build capital to deal with uncertainties and to deal with opportunities that will inevitably arise.

Financial performance and dividend

Q. What were the one-offs that investors should consider when looking at these numbers?

A. (DJF): I think there are a number of one-offs. Clearly, the big one-off is the US$10.6bn goodwill write-off in North America in our Personal Financial Services business, which essentially wrote off the entire balance of goodwill that was left in that business. On the other side, we had the US$2.4bn gain on the sale of our French regional network. We had about US$6.6bn gains on our own debt, for the fair value of our own debt, which is about US$3bn more than it was the year before – a curious number, not one we put into managed performance, but it clearly impacts the numbers that investors look at. And then I guess finally we had approximately US$1bn of losses that arose from our exposure to financial counterparties who were themselves exposed to the alleged fraud at Madoff. These are the one-offs that I think I would highlight.

Q. I see that HSBC's breaking some record of 15 years of double-digit dividend growth. Does this mark a change in the dividend policy, then?

A. (DJF): We're in unprecedented territory in terms of the turmoil in financial markets. Clearly, the profitability of the financial system has been significantly impacted and the capital requirements that banks are facing are higher than they were by virtue of market expectations, by virtue of regulatory requirements and by virtue of elevated losses that they're suffering. And therefore, the pool of available capital we have to service dividend requirements is lower, and we are cautiously harvesting our capital in such a way that we can continue to grow our business in the future when normal times return. And this was an appropriate point in time to re-base the dividend and that's what we've done.

Q. And also, where do you see the future for the regulatory environment, then?

A. (DJF): The regulatory environment is going to change. There's no question of that. There clearly has to be a response, and there should be a response to the experience of the last several years. I think we're going to see a regulatory regime that is much more focused on supervision rather than relying on market discipline together with quite intricate rules. And I think that just as banks found that the models with which they assessed risk had flaws within them, I think the regulatory framework had models that assessed capital requirements that too, with the benefit of hindsight, have not delivered the result that would have been hoped for. And in particular, as we enter a period of lower economic growth, indeed recession, the pro-cyclicality within the regime is compounding the difficulties that exist within many economies in terms of the availability of credit.

Q. So where will HSBC sit then, within this new regulatory environment that you talk about?

A. (DJF): Well, I think we've got a number of advantages. One, we've always had a very strong core equity Tier 1 ratio and now we're extending that with the rights issue. We didn't build our returns on the basis of leveraging our capital ratio, we built it on good returns on our assets. And we see attractive opportunities in the future, in fact we see an enhanced competitive position by virtue of the fact that many banks with whom we competed historically are much more focusing their operations purely on domestic operations. And that international connectivity space that we operate in, we are having a much larger market share within, and we see that as a good advantage.

The other thing is clearly the diversification of our businesses. Being able to generate capital in multiple geographies from multiple business lines gives us the diversification benefit as to where we deploy our capital and the returns that we can get from it, that I think are attractive to investors as they look at competing propositions for investment.

Q. And looking at the loan impairment charge, US$17bn in 2007, US$25bn last year. Now, against a weakening outlook, how big could it be in 2009?

A. (DJF): I think that's a great question, and we are faced with unprecedented uncertainty. It will be directly proportionate to global unemployment. As I've said before the factors in the US that contributed were to some extent underwriting standards and to a very large extent a weakening economy and rising unemployment. The underwriting factors are largely purged from the system, to the extent to which brokered business came in to us that had been badly underwritten has gone because of the maturity of the books now.

But we are exposed to people not having cash flow because they don't have jobs. And therefore both in the United States and in Europe and elsewhere, as unemployment rises, it will have an impact on consumption, impact on production, impact on jobs, impact on people's ability to manage their affairs.

The flip side, or the mitigating factor to some extent, is the fact that we have globally now, an extremely low interest rate environment. So, to the extent that people are in employment, their ability to maintain their financial commitments in terms of servicing the interest is very much facilitated. And the cash flow benefit that our customers who have borrowed from us have got from lower interest rates is beginning to be quite significant.

But to answer your question, where the number gets to will be entirely dependent on the impact later on this year and into 2010, of the significant stimulus packages that have been put into place around the world.

Global Banking and Markets performance Q. Take us through Global Banking and Markets' performance in 2008.

A. (STG): Well, 2008, as everybody knows, was probably the most difficult year in financial markets since probably the 1930s. Against that backdrop, the Global Banking Markets business delivered a profit before tax of approximately US$3.5bn, down from US$6.1bn in 2007. So a sharp fall but I think the context has to be against our peer group and how many banks actually delivered a profit, at all, in their wholesale banking businesses in 2008. And the answer to that is very, very few. That US$3.5bn is after writing down approximately US$6.1bn, and those were legacy credit positions in the most that actually were put on in 2005, 2006 and the same positions that we were writing down at the half-year in 2008 and indeed the full year in 2007.

So overall, actually, I think the performance of delivering a profit in a year like 2008, after all expenses, after compensation, etc., is probably quite a robust result, relative to our peer group. In absolute terms, of course, it's very disappointing to have any fall in P&L, but the truth of the matter is in a year like 2008 that was pretty unavoidable for us and everybody else.

Now, digging into the numbers, we had great performances in emerging markets which you'd kind of expect us to. We changed the strategy in 2006 to focus on emerging markets and that really paid dividends in both '07 and in '08, because it left us with a much stronger revenue platform than some others. But actually the most interesting thing, or just as interesting, is the fact that we had record foreign exchange profits and they actually came about in London and New York, and record rates profits which actually also came about in London, Paris and New York. So actually, we had really strong results in emerging markets but also in the developed world.

So overall, it's a disappointing year at one level, but actually, relatively speaking, they're a reasonable set of numbers.

Q. Some concerns though, the Assets for Sale portfolio for instance. What's your view on that?

A. (STG): This is a headline number of roughly US$21bn but actually we've stress-tested this number and actually a reasonable stressing of this portfolio for adverse conditions suggests that we might have impairments as much as US$2bn to US$2.5bn on it. Expected losses are US$600m to US$800m. That's in an extreme stress situation.

In actual fact during 2008 our actual losses on this portfolio were of the order of US$200m. So the headline number is a large number but, if you boil it down, the actual losses we're taking on it are not material in the context of an institution of our size and scale.

Q. So, given the bigger picture, what's your market outlook, then, for 2009?

A. (STG): I think 2009 will remain a difficult market. But having said that there's some volatility in the market, there's quite a lot of volume going through – and actually our business started the year reasonably well. We're not out of the woods in terms of the financial crisis, and every day the news stories bring further sources of concern. But I actually think that the markets in 2009, on what we can see so far, will be reasonably manageable for us.

I also think there's an opportunity coming for HSBC's Global Banking and Markets business because, as a number of institutions that have taken government capital are forced to retreat to their domestic markets by the fact that the taxpayers who elect the politicians whose taxpayer money has been put into these institutions, expect it – quite reasonably – to be used domestically, the competition in emerging markets, which of course is our core strength, may actually reduce. That may enable us to grow our market share in those emerging markets, and may also cause us to be able to re-price risk in those emerging markets. Now that, to be honest, is probably a 2010 item, but actually I can see some real opportunities emerging from the current dislocation that's taking place in the banking industry.

Q. Interesting you talk about growth, HSBC has taken a lot of flak for not bulging up to bulge bracket status. So what's your view on that today?

A. (STG): That's a fair question, because we were criticised that our model for wholesale banking was not the same as a US bulge-bracket broker-dealer model. And in fact, the change of strategy we put in 2006 took us much, much distant from that bulge-bracket broker-dealer model into emerging markets and financing as the core strengths of HSBC.

I guess history would suggest that actually that change of strategy was correct. We were profitable in 2007 and 2008. And the broker-dealer model's obviously been forced to change in the United States. The remaining broker-dealers have had to change their status to become bank holding companies in order to continue with their own strategies. So I think history would judge it as correct that we didn't bulge up into a broker-dealer model, and that we didn't acquire a broker-dealer, but rather that the strategy we chose – which was to adopt a very HSBC idiosyncratic approach to wholesale banking – has worked well.

Current trading and outlook

Q. It's a very tough operating environment, Mike. So how will you be running the business within this environment?

A. (MFG): In the same way as we always do. You start off by knowing your customer, understanding what the customer needs and that normally solves most problems along the way. Clearly, customers' needs now are much more complex than they were 12 months ago. We're going to need to be closer to our customers than ever before.

The great thing about it is that our customers know that HSBC is strongly capitalised. They know it is operating as normal. And as such, a large amount of business is coming to us across all our different franchises across the world. So we will continue to work with them.

Our colleagues around the world are working much more closely together. We're joining up the company, both technology-wise and with people, and staff engagements – all the different measures used to mould a bank together, a bank that is the number one brand in banking across the world today, up from being the number four brand only 12 months ago.

So we've got lots of things to go for. We're going to be very, very careful. Lots of things happen in this type of environment, operational losses, risk is higher. We have to work through all those things. We will certainly keep our investors advised as to what is going on, good communication, working with our regulators around the world, and making sure that everything is gelling together.

And certainly from the first few weeks of this year, what I'm seeing are good results – results higher than I expected, candidly, for the first month. I hope it's going to continue. Obviously, it's an uncertain world, but HSBC is certain that it's going to be a winner out of this situation.

Q. So Mike, what do you see as the outlook for 2009?

A. (MFG): Without a doubt, 2009 is going to be very difficult. But the one thing that gives me solace is that HSBC has been through a number of these types of situations around the world, obviously not a global one, but certainly regional ones. And the people who've managed those types of crises, those types of issues, are the same people who are managing collectively today the global situation that we find ourselves in. And because of that, I think, HSBC is in a unique management position. And I'm confident that whatever is thrown to us in 2009, the HSBC management team will be well able to handle it.

Q. And you Stephen?

A. (SKG): We see 2009 as a difficult year, there's no two ways about it. The world economy may well decline for the first time in 50 years this year. I mean, that's an extraordinary thing.

Asia has clearly slowed. There are still some remarkable performances there. I mean, I think China will continue to perform pretty robustly at at least 7%. India will put in quite a strong performance but there are a number of other Asian economies that are going to be weaker. Europe is clearly in recession virtually everywhere. America shows no signs yet of bottoming out.

An enormous amount of stimulus is being put into these economies and I have to say that I think governments are increasingly well coordinated in what they're doing. And I can't believe that all of this stimulus will have no effect. So at some point this will bottom out. Nonetheless, 2009 the best assumption is going to be a very difficult year.

In those circumstances HSBC, I believe, is as well placed as anyone. We are strongly capitalised. We do have a very liquid balance sheet. We do have franchises in the strong, fast-growing parts of the world. Our strategy is to focus on those economies. I believe actually that this crisis will accelerate the shift in the world's centre of economic gravity from west to east.

So our strategy is absolutely still intact. We will continue to invest in that strategy. We will continue to execute that strategy, as far as our customers are concerned, on a daily basis.

The going will be tough in so many ways but I can't think of a better institution than HSBC to see through this and actually to strengthen its position relative to our competitors in so doing.