

HSBC HOLDINGS PLC  
Form 20-F  
March 10, 2008

**As filed with the Securities and Exchange Commission on March 10, 2008.**

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**SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549**

## **FORM 20-F**

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REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR 12(g) OF THE  
SECURITIES EXCHANGE ACT OF 1934

**or**

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934 For the fiscal year ended December 31, 2007

**or**

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934

For the transition period from N/A to N/A

Commission file number: 1-14930

### **HSBC Holdings plc**

**(Exact name of Registrant as specified in its charter)**

**N/A**

(Translation of Registrant's name into English)

**United Kingdom**

(Jurisdiction of incorporation or organisation)

8 Canada Square  
London E14 5HQ  
United Kingdom

(Address of principal executive offices)

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(Name, Telephone, Email and/or Facsimile number and Address of Company Contact Person)

Securities registered or to be registered pursuant to Section 12(b) of the Securities Exchange Act of 1934:

Title of each class

Name of each exchange on which registered

Ordinary Shares, nominal value US\$0.50 each.

London Stock Exchange  
Hong Kong Stock Exchange  
Euronext Paris  
New York Stock Exchange\*

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American Depository Shares, each representing 5 Ordinary Shares of nominal value US\$0.50 each.	New York Stock Exchange
6.20% Non-Cumulative Dollar Preference Shares, Series A	New York Stock Exchange*
American Depository Shares, each representing one-fortieth of a Share of 6.20% Non-Cumulative Dollar Preference Shares, Series A	New York Stock Exchange
5.25% Subordinated Notes 2012	New York Stock Exchange
6.5% Subordinated Notes 2036	New York Stock Exchange
6.5% Subordinated Notes 2037	New York Stock Exchange

Securities registered or to be registered pursuant to Section 12(g) of the Securities Exchange Act of 1934: None

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Securities Exchange Act of 1934: None

Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of the period covered by the annual report:

Ordinary Shares, nominal value US\$0.50 each	11,829,052,317
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Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes

No

If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.

Yes

No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes

No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer

Indicate by check mark which basis of accounting the registrant has used to prepare the financial statements included in this filing:

US GAAP

International Financial Reporting  
Standards as issued by the  
International Accounting Standards  
Board

Other

If "Other" has been checked in response to the previous question indicate by check mark which financial statement item the registrant has elected to follow.

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If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes

No

\* Not for trading, but only in connection with the registration of American Depository Shares.

HSBC HOLDINGS PLC

**Annual Report and Accounts 2007**

Headquartered in London, HSBC is one of the largest banking and financial services organisations in the world. Its international network comprises some 10,000 properties in 83 countries and territories in Europe; Hong Kong; Rest of Asia-Pacific, including the Middle East and Africa; North America and Latin America.

With listings on the London, Hong Kong, New York, Paris and Bermuda stock exchanges, shares in HSBC Holdings plc are held by about 200,000 shareholders in over 100 countries and territories. The shares are traded on the New York Stock Exchange in the form of American Depositary Shares.

HSBC provides a comprehensive range of financial services to 128 million customers through four customer groups and global businesses: Personal Financial Services (including consumer finance); Commercial Banking; Global Banking and Markets; and Private Banking.

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## Certain defined terms



Unless the context requires otherwise, "HSBC Holdings" means HSBC Holdings plc and "HSBC" or the "Group" means HSBC Holdings together with its subsidiaries. Within this document the Hong Kong Special Administrative Region of the

People's Republic of China is referred to as "Hong Kong". When used in the terms "shareholders' equity" and "total shareholders' equity", "shareholders" means holders of HSBC Holdings ordinary shares and those preference shares classified as equity.

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HSBC HOLDINGS PLC

## Financial Highlights

For the year

- Total operating income up 25.0 per cent to US\$87,601 million (2006: US\$70,070 million).
- Net operating income up 12.7 per cent to US\$61,751 million (2006: US\$54,793 million).
- Group pre-tax profit up 9.6 per cent to US\$24,212 million (2006: US\$22,086 million).
- Profit attributable to shareholders of the parent company up 21.2 per cent to US\$19,133 million (2006: US\$15,789 million).
- Return on average invested capital of 15.3 per cent (2006: 14.9 per cent).
- Earnings per ordinary share up 17.9 per cent to US\$1.65 (2006: US\$1.40).

At the year-end

- Total equity up 17.8 per cent to US\$135,416 million (2006: US\$114,928 million).
- Customer accounts and deposits by banks up 23.3 per cent to US\$1,228,321 million (2006: US\$996,528 million).
- Risk-weighted assets up 19.7 per cent to US\$1,123,782 million (2006: US\$938,678 million).

Dividends and capital position

- Total dividends declared in respect of 2007 of US\$0.90 per share, an increase of 11.1 per cent over dividends for 2006; fourth interim dividend for 2007 of US\$0.39 per share, an increase of 8.3 per cent.
- Tier 1 capital ratio of 9.3 per cent and total capital ratio of 13.6 per cent.

**Dividends per share<sup>1</sup>**  
(US dollars)

**Return on average  
invested capital**  
(per cent)

**Earnings per share**  
(US dollars)

**Cost efficiency ratio**  
(per cent)

1 Dividends declared in the year per ordinary share.

Data for 2004 to 2007 are presented based on financial statements prepared in accordance with IFRSs; data for 2003 in accordance with UK GAAP. Further information about the results is given in the consolidated income statement on page 337.

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HSBC HOLDINGS PLC

**Financial Highlights** (continued)*Ratios / 5-year comparison***Capital and performance ratios**

	2007 %	2006 %
<b>Capital ratios</b>		
Tier 1 capital	9.3	9.4
Total capital	13.6	13.5
<b>Performance ratios</b>		
Return on average invested capital <sup>1</sup>	15.3	14.9
Return on average total shareholders' equity <sup>2</sup>	15.9	15.7
Post-tax return on average total assets	0.97	1.00
Post-tax return on average risk-weighted assets	1.95	1.93
<b>Credit coverage ratios</b>		
Loan impairment charges as a percentage of total operating income	19.61	15.05
Loan impairment charges as a percentage of average gross customer advances	1.97	1.39
Total impairment allowances outstanding as a percentage of impaired loans at the year-end	104.9	98.5
<b>Efficiency and revenue mix ratios</b>		
Cost efficiency ratio <sup>3</sup>	49.4	51.3
As a percentage of total operating income:		
□ net interest income	43.1	49.2
□ net fee income	25.1	24.5
□ net trading income	11.2	11.7
<b>Financial ratio</b>		
Average total shareholders' equity to average total assets	5.69	5.97

**Share information at the year-end**

	2007	2006
US\$0.50 ordinary shares in issue (million)	11,829	11,572
Market capitalisation (billion)	US\$198	US\$212
Closing market price per ordinary share:		
□ London	£8.42	£9.31
□ Hong Kong	HK\$131.70	HK\$142.40
Closing market price per American Depositary Share <sup>4</sup>	US\$83.71	US\$91.65

	Over 1 year	Over 3 years	Over 5 years
HSBC total shareholder return to 31 December 2007 <sup>5</sup>	95.6	111.3	158.8
Benchmarks:			
□ FTSE 100	107.4	148.4	194.6
□ MSCI World	108.1	140.8	182.0

*For footnotes, see page 4.*

*The consolidated financial statements of HSBC and the separate financial statements of HSBC Holdings have been prepared in accordance with International Financial Reporting Standards (IFRSs) as endorsed by the European Union (EU). EU-endorsed IFRSs may differ from IFRSs as published by the International Accounting Standards Board (IASB) if, at any point in time, new or amended IFRSs have not been endorsed by the EU. At 31 December 2007, there were no unendorsed standards effective for the year ended 31 December 2007 affecting these consolidated and separate financial statements, and there was no difference between IFRSs endorsed by the EU and IFRSs issued by the IASB in terms of their application to HSBC. Accordingly, HSBC's financial statements for the year ended 31 December 2007 are prepared in accordance with IFRSs as issued by the IASB.*

*Information for 2003 has been prepared under previous HSBC policies in accordance with UK Generally Accepted Accounting Principles (UK GAAP), which are not comparable with IFRSs.*

*HSBC uses the US dollar as its presentation currency because the US dollar and currencies linked to it form the major currency bloc in which HSBC transacts its business. Unless otherwise stated, the information presented in this document has been prepared in accordance with IFRSs.*

*When reference to underlying or underlying basis is made in tables or commentaries, comparative information has been expressed at constant currency (see page 131) and adjusted for the effects of acquisitions and disposals. A reconciliation of reported and underlying profit before tax is presented on page 15.*

[Back to Contents](#)**Five-year comparison**

	Amounts in accordance with IFRSs <sup>8</sup>				Amounts in accordance with UK GAAP <sup>9</sup>
	2007 US\$m	2006 US\$m	2005 US\$m	2004 US\$m	2003 US\$m
<b>For the year</b>					
Net interest income	37,795	34,486	31,334	31,099	25,598
Other operating income	49,806	35,584	30,370	24,889	15,474
Loan impairment charges and other credit risk provisions	(17,242)	(10,573)	(7,801)	(6,191)	□
Provisions for bad and doubtful debts	□	□	□	□	(6,093)
Total operating expenses	(39,042)	(33,553)	(29,514)	(26,487)	(22,532)
Profit before tax	24,212	22,086	20,966	18,943	12,816
Profit attributable to shareholders of the parent company	19,133	15,789	15,081	12,918	8,774
Dividends	10,241	8,769	7,750	6,932	6,532
<b>At the year-end</b>					
Called up share capital	5,915	5,786	5,667	5,587	5,481
Total shareholders' equity	128,160	108,352	92,432	85,522	□
Shareholders' funds	□	□	□	□	74,473
Capital resources <sup>10</sup>	152,640	127,074	105,449	90,780	74,042
Customer accounts	1,096,140	896,834	739,419	693,072	573,130
Undated subordinated loan capital	2,922	3,219	3,474	3,686	3,617
Preferred securities and dated subordinated loan capital <sup>11</sup>	49,472	42,642	35,856	32,914	17,580
Loans and advances to customers <sup>12,13</sup>	981,548	868,133	740,002	672,891	528,977
Total assets	2,354,266	1,860,758	1,501,970	1,279,974	1,034,216
	US\$	US\$	US\$	US\$	US\$
<b>Per ordinary share</b>					
Basic earnings	1.65	1.40	1.36	1.18	0.84
Diluted earnings	1.63	1.39	1.35	1.17	0.83
Dividends <sup>14</sup>	0.87	0.76	0.69	0.63	0.60
Net asset value at year-end	10.72	9.24	8.03	7.66	6.79
<b>Share information</b>					
US\$0.50 ordinary shares in issue (millions)	11,829	11,572	11,334	11,172	10,960
	%	%	%	%	%
<b>Financial ratios</b>					
Dividend payout ratio <sup>15</sup>	52.7	54.3	50.7	53.4	60.6
Post-tax return on average total assets	0.97	1.00	1.06	1.14	1.01
Return on average total shareholders' equity	15.9	15.7	16.8	16.3	□
Return on average shareholders' funds	□	□	□	□	13.0
Average total shareholders' equity to average total assets	5.69	5.97	5.96	6.35	□
Average shareholders' funds to average total assets	□	□	□	□	7.06
<b>Capital ratios</b>					
Tier 1 capital	9.3	9.4	9.0	8.9	8.9



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Total capital	<b>13.6</b>	13.5	12.8	12.0	12.0
<b>Foreign exchange translation rates to US\$</b>					
Closing □ £:US\$1	<b>0.498</b>	0.509	0.581	0.517	0.560
□ □:US\$1	<b>0.679</b>	0.759	0.847	0.733	0.793
Average □ £:US\$1	<b>0.500</b>	0.543	0.550	0.546	0.612
□ □:US\$1	<b>0.731</b>	0.797	0.805	0.805	0.885

*For footnotes, see page 4.*

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HSBC HOLDINGS PLC

## Financial Highlights (continued)

Cautionary statements

Footnotes to Financial Highlights

- 1 The definition of return on average invested capital and a reconciliation to the equivalent GAAP measures are set out on page 12.
- 2 The return on average total shareholders' equity is defined as profit attributable to shareholders of the parent company divided by average total shareholders' equity.
- 3 The cost efficiency ratio is defined as total operating expenses divided by net operating income before loan impairment charges and other credit risk provisions.
- 4 Each American Depositary Share (ADS) represents five ordinary shares.
- 5 Total shareholder return is defined on page 12.
- 6 The Financial Times Stock Exchange 100 Index.
- 7 The Morgan Stanley Capital International World Index.
- 8 Data for 2004 exclude the provisions of IAS 32, IAS 39 and IFRS 4, which were adopted for the first time with effect from 1 January 2005.
- 9 Data for 2003 were prepared in accordance with previous HSBC accounting policies under UK GAAP. HSBC's accounting policies under UK GAAP are stated in Note 2 on the Financial Statements in the Annual Report and Accounts 2004.
- 10 Capital resources are total regulatory capital, the calculation of which is set out on page 286.
- 11 Includes perpetual preferred securities, details of which can found in Note 32 on the Financial Statements .
- 12 Net of suspended interest and provisions for bad and doubtful debts (UK GAAP).
- 13 Net of impairment allowances (IFRSs).
- 14 Dividends recorded in the financial statements are dividends per ordinary share declared in a year and are not dividends in respect of, or for, that year. First, second and third interim dividends for 2007, each of US\$0.17 per ordinary share, were paid on 6 July 2007, 4 October 2007 and 18 January 2008 respectively. Note 12 on the Financial Statements provides more information on the dividends declared in 2007. On 3 March 2008 the Directors declared a fourth interim dividend for 2007 of US\$0.39 per ordinary share in lieu of a final dividend, which will be payable to ordinary shareholders on 7 May 2008 in cash in US dollars, or in pound sterling or Hong Kong dollars at exchange rates to be determined on 28 April 2008, with a scrip dividend alternative. The reserves available for distribution at 31 December 2007 were US\$15,551 million. Quarterly dividends of US\$15.50 per 6.20 per cent non-cumulative US dollar preference share, Series A (Series A dollar preference share), equivalent to a dividend of US\$0.3875 per Series A ADS, each of which represents one-fortieth of a Series A dollar preference share, were paid on 15 March 2007, 15 June 2007, 15 September 2007 and 15 December 2007.
- 15 Dividends per share expressed as a percentage of earnings per share (2003: excluding goodwill amortisation).

## Cautionary Statement Regarding Forward-Looking Statements

The Annual Report and Accounts 2007 contains certain forward-looking statements with respect to the financial condition, results of operations and business of HSBC.

Statements that are not historical facts, including statements about HSBC's beliefs and expectations, are forward-looking statements. Words such as "expects", "anticipates", "intends", "plans", "believes", "seeks", "estimates", "potential" and "reasonably possible", variations of these words and similar expressions are intended to identify forward-looking statements. These statements are based on current plans, estimates and projections, and

therefore undue reliance should not be placed on them. Forward-looking statements speak only as of the date they are made, and it should not be assumed that they have been revised or updated in the light of new information or future events.

Written and/or oral forward-looking statements may also be made in the periodic reports to the United States Securities and Exchange Commission, summary financial statements to shareholders, proxy statements, offering circulars and prospectuses, press releases and other written materials, and in oral statements made by HSBC's Directors, officers or employees to third parties, including financial analysts.

Forward-looking statements involve inherent risks and uncertainties. Readers are cautioned that a number of factors could cause actual results to differ, in some instances materially, from those anticipated or implied in any forward-looking statement. These factors include, among others:

- changes in general economic conditions in the markets in which HSBC operates, such as:
  - continuing or deepening recessions and employment fluctuations;
  - changes in foreign exchange rates, in both market exchange rates (for example, between the US dollar and pound sterling) and government-established exchange rates (for example, between the Hong Kong dollar and US dollar);
  - volatility in interest rates;
  - volatility in equity markets, including in the smaller and less liquid trading markets in Asia and Latin America;

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- lack of liquidity in wholesale funding markets;
- illiquidity and downward price pressure in national real estate markets, particularly consumer-owned real estate markets;
- the emergence of structural inflationary pressures from rising energy, raw material, food and labour costs particularly in emerging economies experiencing strong domestic growth and capacity constraints;
- the impact of lower than expected investment returns on the funding of private and public sector defined benefit pensions;
- the effect of unexpected changes in actuarial assumptions on longevity which would influence the funding of private and public sector defined benefit pensions; and
- consumer perception as to the continuing availability of credit, and price competition in the market segments served by HSBC.
- changes in governmental policy and regulation, including:
  - the monetary, interest rate and other policies of central banks and other regulatory authorities, including the UK Financial Services Authority, the Bank of England, the Hong Kong Monetary Authority, the US Federal Reserve, the US Securities and Exchange Commission, the US Office of the Comptroller of the Currency, the European Central Bank, the People's Bank of China and the central banks of other leading economies and markets where HSBC operates;
  - expropriation, nationalisation, confiscation of assets and changes in legislation relating to foreign ownership;
  - initiatives by local, state and national regulatory agencies or legislative bodies to revise the practices, pricing or responsibilities of financial institutions serving their consumer markets;
  - changes in bankruptcy legislation in the principal markets in which HSBC operates and the consequences thereof;
  - general changes in governmental policy that may significantly influence investor decisions, in particular markets in which HSBC operates;
  - other unfavourable political or diplomatic developments producing social instability or legal uncertainty which in turn may affect demand for HSBC's products and services;
  - the costs, effects and outcomes of regulatory reviews, actions or litigation, including any additional compliance requirements; and
  - the effects of competition in the markets where HSBC operates including increased competition from non-bank financial services companies, including securities firms.
- factors specific to HSBC:
  - the success of HSBC in adequately identifying the risks it faces, such as the incidence of loan losses or delinquency, and managing those risks (through account management, hedging and other techniques). Effective risk management depends on, among other things, HSBC's ability through stress testing and other techniques to prepare for events that cannot be captured by the statistical models it uses.



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HSBC HOLDINGS PLC

## Report of the Directors: Business Review

*Group Chairman's statements*

### Group Chairman's statement

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2007 was a year when large parts of the international financial system came under extraordinary strain. For HSBC to achieve another new high in earnings, despite these conditions and the exceptionally weak performance of our US business, underscores the value of the strategic focus we announced early last year to drive sustainable growth by concentrating on the faster growing markets of the world.

Pre-tax profits in 2007 increased by 10 per cent to US\$24 billion and earnings per share rose by 18 per cent to US\$1.65. Excluding the dilution gains arising from our strategic investments in mainland China, which I highlighted at the interim stage, profits grew by 5 per cent. Consistent with our strategy of focusing on emerging markets where we are the world's leading international bank, profits from those businesses, excluding dilution gains, grew by 41 per cent to US\$15 billion.

Our return on shareholders' equity exceeded 15 per cent, revenue growth was in double digits for the fifth year running, our cost efficiency ratio improved and our capital ratios remained strong. HSBC's financial strength in terms of both capital and liquidity is a powerful driver of sustainable growth and helps ensure continued resilience.

### Strong operating performance in 2007

We produced exceptionally strong results in Asia-Pacific, Latin America and the Middle East while facing considerable business challenges in North America. In our customer groups, we also achieved record results in Commercial Banking and Private Banking, and a strong performance in Global Banking and Markets, despite write-downs arising from market turbulence in the second half of the year. In addition, Personal Financial Services produced record profits in emerging markets. Within

these customer groups, our insurance operations made further progress.

Our North American results continue to be adversely affected by high loan impairment charges as we respond to the impact on our portfolio of credit deterioration arising largely from housing market weakness in the US. The management team has taken vigorous action to address and mitigate the problem. In Europe, excluding the

positive effect of movements in the fair value of HSBC's own debt, performance was broadly in line with 2006. In the UK, Commercial Banking generated pre-tax profits of over US\$2 billion for the first time and, in Turkey, further expansion of the branch network helped drive strong organic growth in numbers of personal and business customers.

### **Financial strength underpins our progressive dividend policy**

The Directors have declared a fourth interim dividend for 2007 of US\$0.39 per ordinary share (in lieu of a final dividend) which, together with the first three interim dividends for 2007 of US\$0.17 already paid, will make a total distribution in respect of the year of US\$0.90 per share (US\$0.81 per share in respect of 2006), an increase of 11.1 per cent. The dividend will be payable on 7 May 2008 with a scrip dividend alternative, to shareholders on the register on 25 March 2008. HSBC's dividend has increased by 10 per cent or more every year for 15 years.

### **A clear and compelling strategy playing to our strengths**

At the beginning of 2007, we refreshed our strategy, considering how we should shape HSBC for the future. Our deliberations were influenced by some fundamental long-term trends that will shape tomorrow's world: emerging markets will continue to grow faster than mature ones; world trade will continue to grow faster than world output; and people are living longer than ever before with all the implications that has for long-term savings and pensions.

Our thinking was also informed by a clear appreciation of HSBC's strengths. We believe that the global leadership we have built in emerging markets and in trade, and our international perspective, are compelling advantages that set HSBC apart for our customers, our shareholders and our people.

As we explained in March 2007, our conclusion was that the Group should place renewed emphasis on investing in fast moving emerging markets in Asia-Pacific, the Middle East and Latin America. We

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believe we can grow strongly and sustainably. We achieved our position as the number one international bank in Asia-Pacific and the Middle East over many years; by contrast, we have built one of Latin America's largest financial services businesses in little more than a decade.

In mature markets, we are determined to focus our businesses on areas where we can build on our unique global franchise, so as to benefit from the long-term trend of increasing international connectivity. We have international customer bases across many of our businesses, from the largest corporates, through to small or medium-sized enterprises, to the internationally mobile mass affluent and other personal customers with specific international requirements. We have developed a clear approach which is enabling our business to focus strongly on these groups of customers now and in the years ahead.

Where opportunities arise, we shall seek to redeploy capital towards emerging markets through divestment of assets of greater strategic value to others. In France, we have received a firm cash offer of US\$3.1 billion for our seven, separately branded, regional banks and have entered into exclusive discussions. This potential transaction, which is subject to necessary approvals and consultation, could complete in mid-2008. We remain committed to France through our HSBC-branded network serving retail and commercial customers and through our activities in Global Banking and Markets, Private Banking, asset management and insurance. During 2007, we acquired the 50 per cent of Erisa, our French insurance business, which we did not own.

We will also build businesses, in both our emerging and mature markets, that help our customers with their long-term savings needs, as demographics and wealth creation trends around the world make this ever more important to them.

Finally, we will shape our business operations so that we use our scale to deliver better, more efficient services to our customers. Their use of technology increasingly dictates how they interact with us. We increasingly employ technology to create better products which we can deliver globally at lower cost. As we grow our direct banking business, we will create opportunities to meet more of our customers' financial needs.

### **Building on our position as the world's leading international emerging markets bank**

During 2007, we continued to build our businesses in emerging markets organically. For example, on a like-for-like basis, risk-weighted assets in these areas grew by 42 per cent compared with 16 per cent for the Group as a whole.

As the leading international bank in the country of our birth, China, we were delighted to be among the first to incorporate locally in the mainland. We have built the largest branch network of any international bank and we have significant and profitable strategic investments in our Chinese associates.

In mainland China, through our own businesses and in conjunction with our associates, we achieved for the first time in our history a profit before tax of over US\$1 billion, in addition to over US\$7 billion generated in Hong Kong.

As China continues to reshape itself as a 21st century powerhouse, HSBC seeks to play a constructive role in its continued progressive economic and social development. We were the first international bank to establish and open a rural bank. Hang Seng Bank has agreed to acquire 20 per cent of Yantai City Commercial Bank in the fast growing Bohai region of China.

Elsewhere in Asia-Pacific, we have sought to further strengthen our position through a series of investments in faster-growing economies. In South Korea, we have agreed to acquire 51 per cent of Korea Exchange Bank for US\$6.5 billion, subject to regulatory approvals. In Taiwan, we acquired Chailease Credit Services, a factoring company serving commercial customers, and agreed to acquire the assets, liabilities and operations of The Chinese Bank, which will extend our network by 39 branches and bring us many new customers.

As foreign investment rules are eased, we have made significant investments to expand our business in Vietnam with the acquisition of a further 5 per cent interest in Techcombank, bringing our stake to 14.4 per cent,



and the purchase for some US\$255 million of a 10 per cent interest in Bao Viet, the leading insurance company in the country.

The latter investment reflects our determination to increase the contribution of insurance to Group earnings. We also entered into agreements to invest in a 26 per cent interest in a new life insurance joint venture in India, in partnership with two of the larger state-owned banks, and to acquire just under 50 per cent of Hana Life Insurance Company in South Korea. We have entered a number of strategic

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HSBC HOLDINGS PLC

## **Report of the Directors: Business Review**

(continued)

### *Group Chairman's statements*

alliances to ensure that we have the best products for our customers and the support to grow our activities.

A fifth consecutive year of rising oil prices facilitated growth in public and private investment in the Middle East. As a result, infrastructure development accelerated and consumption and employment rose. Our businesses in the Middle East were well positioned to benefit from this and have had an excellent year.

Our acquisition of Grupo Banistmo in Central America and Banco Nazionale in Argentina in 2006 strengthened our existing business. 2007 has been a year of integrating these operations. It is a testimony to the strength of our Latin American businesses that we have been able to grow profits by 26 per cent to over US\$2 billion while investing in the integration, and despite the increase in loan impairment charges in Mexico as our loan portfolio began to mature.

### **A people business**

It is people, of course, who define an organisation; and any business's success is dependent on the calibre of its staff. 2007 was a demanding year in many respects and it is testament to the talent and professionalism of my 330,000 colleagues around the world that HSBC successfully met its challenges and excelled in so many areas. I would like to take this opportunity to extend my personal thanks to my colleagues – their commitment and expertise have greatly benefited the Group and our shareholders.

### **Measuring the results of our strategy**

Today we are publishing, for the first time, the key metrics which we will use to measure our performance in future. These include a number of measures that cover financial performance, customer recommendation and employee engagement.

In financial terms we are aiming for a return on equity in a range over the investment cycle of 15-19 per cent; a cost efficiency ratio in the range of 48-52 per cent; Tier 1 capital under the Basel II framework of 7.5 -9.0 per cent; and total shareholder return in the top half of that achieved by our peers.

Financial measures are important but not sufficient: it is our people and our relationship with customers that will drive our business and ultimately determine our success. For the first time, in 2007, 290,000 HSBC colleagues completed our new global people survey, allowing us to benchmark ourselves and, over time, raise our game. Similarly, we have established customer engagement metrics which enable us to measure and improve our service to them. We have set ourselves challenging targets to

increase both employee and customer engagement. They will help us build on our position as the world's number one global banking brand.

### **Changes to your Board**

Independent oversight of our company and of the execution of strategy is the responsibility of one of the most experienced and international Boards in the world. I am delighted that we will benefit from international business leaders of the calibre of José Luis Durán and Sam Laidlaw, who joined the Board as independent non-executive Directors on 1 January 2008. We also welcome two other global business leaders, Safra Catz and Narayana

Murthy, who will join as independent non-executive Directors on 1 May 2008.

The Board will be further strengthened by the appointment of three executive directors: Vincent Cheng, effective 1 February 2008; and Sandy Flockhart and Stuart Gulliver, who will join the Board, effective 1 May 2008. These are three of our most talented and experienced executives - all emerging market specialists.

Baroness Dunn, Sir Brian Moffat and Lord Butler will retire as non-executive Directors at HSBC's Annual General Meeting on 30 May 2008 and will not seek re-election. I should like to pay tribute to their tremendous contribution to HSBC. We have been privileged to enjoy their counsel and stewardship for so many years.

### **HSBC's core strength in uncertain times**

The outlook for the rest of 2008 is uncertain. The economic slowdown and the credit outlook in the US may well get worse before they get better. With significant parts of the international financial system in developed markets still in difficulty, HSBC's emphasis on faster growing emerging markets means that we are better positioned than many of our competitors.

Emerging markets have only partly decoupled from the US. Hence, while these economies are exhibiting more domestic momentum, they will not be entirely immune from the impact of a US slowdown. However, the major long-term trends are still intact. Emerging markets will continue to outperform mature economies; and world growth, even in this year of relative weakness for the US economy, will be reasonable - albeit slower than in 2007. Meanwhile, trade and investment patterns will continue to evolve to reflect a more interconnected world, notwithstanding some signs of protectionist sentiment in several key mature markets. In particular, we will see further strategic investments

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from emerging markets into mature markets, as well as into other emerging markets, a trend from which we are well placed to benefit.

2008 is likely to be a year of caution in the financial sector until liquidity, transparency and the proper pricing of risk return to financial markets. We expect to be able to improve margins on the use of our capital and we will continue to invest in building market presence at a time when others with weaker capital positions are constrained.

The fundamentals of HSBC are very strong. The deleveraging of the financial system clearly plays to HSBC's strengths, given our conservative balance sheet and international presence. There can be few banks in the world that are better positioned to withstand market turbulence and grasp strategic opportunities. We will continue to focus HSBC on the parts of the global economy that promise the best prospects for higher growth over the long term. We will continue to invest for profitable growth in line with our strategy, and we will do so while maintaining HSBC's financial strength, which is at the heart of our success.

S K Green, *Group Chairman*  
3 March 2008

HSBC HOLDINGS PLC

**Report of the Directors: Business Review**

(continued)

*Principal activities / Strategic direction / KPIs*

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**Principal activities**

HSBC is one of the largest banking and financial services organisation in the world, with a market capitalisation of US\$198 billion at 31 December 2007.

Through its subsidiaries and associates, HSBC provides a comprehensive range of banking and related financial services. Headquartered in London, HSBC operates through long-established businesses and has an international network of some 10,000 properties in 83 countries and territories in five geographical regions: Europe; Hong Kong; Rest of Asia-Pacific, including the Middle East and Africa; North America and Latin America. Within these regions, a comprehensive range of financial services is offered to personal, commercial, corporate, institutional, investment and private banking clients. Services are delivered primarily by domestic banks, typically with large retail deposit bases, and consumer finance operations. Taken together, the five largest customers of HSBC do not account for more than one per cent of HSBC's income.

The principal acquisitions made during the year are described on page 415. There were no significant disposals.

**Strategic direction**

HSBC's strategic direction reflects its position as "The world's local bank", combining the largest global emerging markets banking business and a uniquely cosmopolitan customer base with an extensive international network and substantial financial strength.

The Group's strategy is aligned with key trends which are shaping the global economy. In particular, HSBC recognises that, over the long-term, emerging markets are growing faster than developed economies, world trade is expanding at a greater rate than GDP and life expectancy is lengthening everywhere. Against this backdrop, HSBC's strategy is focused on delivering superior growth and earnings over time by building on the Group's heritage and skills. Its origins in trade in Asia have had a considerable influence over the development of the Group and, as a consequence, HSBC has established a longstanding presence in many countries. This local knowledge and international breadth is supported by a substantial financial capability founded on balance sheet strength.

HSBC is, therefore, reshaping its business by investing primarily in the faster growing emerging markets and, in developed markets, focusing on businesses which have international connectivity. Central to these activities is the maintenance of HSBC's financial strength and continued investment in the business.

The Group has identified three main business models for its customer groups and global businesses that embody HSBC's areas of natural advantage:

- businesses with international customers for whom emerging markets connectivity is crucial – Global Banking and Markets, and Private Banking;
- businesses with local customers where efficiency can be enhanced through global scale – the small business segment of Commercial Banking and the mass affluent segment of Personal Financial Services; and
- products where global scale is possible through building efficiency, expertise and brand – global product platforms such as cards and direct banking.

The means of executing the strategy, and further integrating the company, are clear:

- the HSBC brand and global networks will be leveraged to reach new customers and offer further services to existing clients;

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- efficiency will be enhanced by taking full advantage of local, regional and global economies of scale in particular by adopting a common systems architecture; and
- appropriate objectives and incentives will be adopted to motivate and reward staff for being fully engaged in delivering the strategy.

## Key performance indicators

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The Board of Directors and the Group Management Board monitors HSBC's progress against its strategic objectives. Progress is assessed by comparison with the Group's strategy, its operating plan targets and its historical performance using both financial and non-financial measures.

As a prerequisite for the vesting of performance shares, the Remuneration Committee must satisfy itself that HSBC's financial performance has shown a sustained improvement in the period since the award date. In determining this, the Remuneration Committee takes into account HSBC's financial performance with regard to the financial key performance indicators (KPIs) described below. For awards made since 2005, the financial KPIs are

compared with the same group of 28 comparator banks as for the total shareholder return (TSR) performance condition.

### Financial KPIs

To support the Group's strategy and ensure that HSBC's performance can be monitored, management utilises a number of financial KPIs. The table below presents these KPIs for the period from 2004 to 2007. At a business level, the KPIs are complemented by a range of benchmarks which are relevant to the planning process and to reviewing business performance.

HSBC is publishing a number of key targets against which future performance can be measured. Financial targets have been set as follows: the return on average total shareholders' equity over the medium term has been set at 15-19 per cent; the cost efficiency ratio has been set in the range of 48-52 per cent; and the TSR in the top half of that achieved by peers. The cost efficiency ratio has been set as a range within which the business is expected to remain in order to accommodate the need for continued investment in support of future business growth.

### Financial KPIs – trend analysis

	2007 %	2006 %	2005 %	2004 <sup>10</sup> %
Revenue growth <sup>1</sup>	20.8	13.4	12.2	□
Revenue mix <sup>2</sup>				
Net interest income	47.8	52.8	54.4	60.6
Net fee income	27.9	26.3	25.1	25.2
Other income <sup>3</sup>	24.3	20.9	20.5	14.2
Cost efficiency <sup>4</sup>	49.4	51.3	51.2	51.6
Credit performance as measured by risk adjusted margin <sup>5</sup>	6.0	6.3	6.3	6.8
Return on average invested capital <sup>6</sup>	15.3	14.9	15.9	15.0
Dividends per share growth <sup>7</sup>	11.1	11.0	10.6	10.0
Earnings per ordinary share <sup>8</sup> (US\$)	1.65	1.40	1.36	1.18

Return on average total shareholders' equity	<b>15.9</b>	15.7	16.8	16.3
	<b>Over 1 year</b>	<b>Over 3 years</b>	<b>Over 5 years</b>	
<b>Total shareholder return</b>				
HSBC TSR	<b>95.6</b>	<b>111.3</b>	<b>158.8</b>	
Benchmarks:				
□ FTSE 100	107.4	148.4	194.6	
□ MSCI World	108.1	140.8	182.0	

- 1 *The percentage increase in net operating income before loan impairment and other credit risk charges since the previous year.*
- 2 *As a percentage of net operating income before loan impairment charges and other credit risk provisions.*
- 3 *Other income comprises net operating income before loan impairment charges and other credit risk provisions less net interest income and net fee income.*
- 4 *Total operating expenses divided by net operating income before loan impairment and other credit risk charges.*
- 5 *Net operating income divided by average risk-weighted assets.*
- 6 *Profit attributable to ordinary shareholders divided by average invested capital.*
- 7 *The percentage increase in dividends per share since the previous year, based on the dividends paid in respect of the year to which the dividend relates.*
- 8 *Basic earnings per ordinary share is defined in Note 13 on the Financial Statements.*
- 9 *The return on average total shareholders' equity is defined as profit attributable to shareholders of the parent company divided by the average total shareholders' equity.*
- 10 *Presentational changes introduced under IFRSs on 1 January 2005 distort comparison of 2004 data with succeeding years.*



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HSBC HOLDINGS PLC

**Report of the Directors: Business Review**

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KPIs

**Revenue growth** provides an important guide to the Group's success in generating business. In 2007, total revenue grew by 20.8 per cent to US\$79.0 billion, 13.5 per cent on an underlying basis, reflecting HSBC's expansion into new products and markets, improved brand recognition and refinements in segmentation to better meet customer needs. The trend maintained the strong performance in 2006 when the underlying increase was 10.5 per cent. Higher revenue was largely driven by balance sheet growth and strong contributions from faster-growing economies. Fair value gains also helped revenue growth. These gains were primarily driven by a widening of credit spreads on debt issued by HSBC Holdings and its subsidiaries and designated at fair value. The movements will reverse over the life of the debt unless it is repaid before its contractual maturity.

**Revenue mix** represents the relative distribution of revenue streams between net interest income, net fee income and other revenue. It is used to understand how changing economic factors affect the Group, to highlight dependence on balance sheet utilisation for income generation and to indicate success in cross-selling fee-based services to customers with loan facilities. This understanding assists management in making business investment decisions. Comparison of the revenue mix since 2005 shows a clear trend of net fee income increasing at a faster rate than net interest income. The percentage of revenue attributable to net interest income fell from 52.8 per cent in 2006 to 47.8 per cent in 2007. Net fee income grew by 1.6 percentage points to 27.9 per cent.

**Cost efficiency** is a relative measure that indicates the consumption of resources in generating revenue. Management uses this to assess the success of technology utilisation and, more generally, the productivity of the Group's distribution platforms and sales forces. The cost efficiency ratio for 2007 improved over the previous two years notwithstanding the continued investment in HSBC's businesses, particularly in emerging markets, and in improving the Group's distribution and technology platforms.

**Credit performance** as measured by risk-adjusted margin is an important gauge for assessing whether credit is correctly priced so that the returns available after recognising impairment charges meet the Group's required return parameters. The ratio for 2007 was 6.0 per cent, showing a decrease of 0.3 percentage points over 2006. The marginal decrease arose from the significant credit losses in the US, partly offset by the increase in income mainly generated from the faster-growing economies.

**Return on average invested capital** measures the return on the capital investment made in the business, enabling management to benchmark HSBC against competitors. In 2007, the ratio of 15.3 per cent was 0.4 percentage points higher than that reported in 2006. This increase reflected the fact that profitability grew faster than the capital utilised in generating the profit. The main drivers were the higher income generated, mainly in the faster-growing economies, which was not consumptive of capital, and the fair value adjustment on the widening of credit spreads on debt issued by HSBC Holdings and its subsidiaries. Dilution gains of US\$1.1 billion made on investments in HSBC's associates also made a positive contribution towards the return on average invested capital ratio.

HSBC aims to deliver sustained **dividend per share growth** for its shareholders. The dividend growth for 2007, which is based on the year to which the dividends relate (rather than when they were paid), amounts to 11.1 per cent, a marginal increase of 0.1 percentage points over 2006. This basis differs from the disclosure in the five-year comparison on page 3. HSBC has delivered a compound rate of increase in dividends of 11.2 per cent per annum over the past five years.

**Basic earnings per share** (EPS) is a ratio that shows the level of earnings generated per ordinary share. EPS is one of two KPIs used in rewarding employees and is discussed in more detail in the Director's Remuneration Report on page 325. EPS for 2007 was US\$1.65, an increase of 17.9 per cent on 2006. This

demonstrated the benefit of diversified earnings as the losses in the US consumer finance business were more than compensated for by strong growth in other markets and products. In 2006, EPS grew by 2.9 per cent over that reported in 2005.

**Return on average total shareholders' equity** measures the return on average shareholders' investment in the business. This enables management to benchmark Group performance against competitors and its own targets. In 2007, the ratio was 15.9 per cent or 0.2 percentage points higher than in 2006. This is in line with management's target of achieving a range of between 15 and 19 per cent.

**Total shareholder return** (TSR) is used as a method of assessing the overall return to shareholders on their investment in HSBC, and is defined as the growth in share value and declared dividend income during the relevant period. TSR is a key performance measure in rewarding employees.

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In calculating TSR, dividend income is assumed to be invested in the underlying shares. As the comparator group includes companies listed on overseas markets, a common currency is used to ensure that TSR is measured on a consistent basis. The TSR benchmark is an index set at 100 and measured over one, three and five years for the purpose of comparison with the performance of a group of competitor banks which reflect HSBC's range and breadth of activities. The TSR levels at the end of 2007 were 95.6, 111.3, and 158.8 over one, three and five years respectively. HSBC's TSR over all above mentioned periods has underperformed the benchmark. This is attributed largely to the impact on the share price of the current weakness in the US sub-prime mortgage business and investor preference over this time for companies with smaller market values, particularly those for which there is the possibility of participating in domestic or regional consolidation.

Management believes that financial KPIs must remain relevant to the business so they may be changed over time to reflect changes in the Group's composition and the strategies employed.

#### Non-financial KPIs

HSBC has chosen four non-financial KPIs which are important to the future success of the Group in delivering its strategic objectives. These non-financial KPIs are currently reported internally within HSBC on a local basis.

#### Employee engagement

Employee engagement is a measure of employees' emotional and rational attachment to HSBC.

In 2007, HSBC conducted its first Global People Survey. This comprised questions designed to measure employee engagement levels consistently across the Group. The survey covers HSBC's entire permanent global workforce, and responses were received from almost 290,000 employees, a response rate of 88 per cent.

The overall employee engagement index score was 60 per cent. The 2008 target is 62 per cent. Survey questions were grouped into twelve dimensions. Employees rated HSBC above the external global norms in all these dimensions. In two dimensions, reputation and corporate responsibility, employees rated HSBC as achieving the external best in class norm. The survey results have been shared with all employees and action plans are being developed at all levels of the organisation.

#### Brand perception

The score for brand perception is set by data from surveys that are conducted by accredited, independent, third party organisations. A weighted score card is used to produce an overall score on a 100 point scale which is then benchmarked against HSBC's main competitors. The scores from each market are weighted according to the risk adjusted revenues earned in that market to obtain the overall company score.

The 2007 brand scores for Personal Financial Services and Commercial Banking were ahead of the competitor averages by 6 and 7 points, respectively, on a 100 point scale. The 2008 brand perception target is to increase the gap to 9 points and 8 points, respectively.

#### Customer satisfaction

HSBC has regularly conducted customer satisfaction surveys in its main markets over many years. HSBC now uses a consistent measure of customer recommendation to gauge customer satisfaction with the services provided by the Group's Personal Financial Services business. This survey is also conducted by accredited, independent, third party organisations and the resulting recommendation scores are benchmarked against competitors.

The 2007 customer recommendation score for Personal Financial Services was ahead of the competitor average by 1 point on a 100 point scale. The 2008 target is to increase that gap to 2.5 points.

#### IT performance and systems reliability

HSBC tracks two key measures as indicators of IT performance; namely, the number of customer transactions processed and the reliability and resilience of systems measured in terms of service availability targets.

**Number of customer transactions processed**

The number of customer transactions processed is a reflection of the increasing usage of IT in each of the delivery channels used to service customers. Its aim is to manage the rate of increase in customer transaction costs effectively and ensure that customer growth is enabled in the appropriate channels. The transition of customer transactions from labour intensive (branch, call centre and others) to automated (credit card, internet, self-service and other e-channels) is occurring. The following chart shows the 2005, 2006 and 2007 volumes per delivery channel:

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HSBC HOLDINGS PLC

## Report of the Directors: Business Review

(continued)

*KPIs / Reconciliation of reported and underlying profit before tax*

### Customer transactions

*The call centre, internet and self-service transaction numbers for 2006 have been restated to align them with the definition of customer transactions adopted in 2007.*

### Percentage of IT services meeting or exceeding targets

HSBC's IT function establishes with its end-users agreed service levels for systems performance, such as systems running 99.9 per cent of the time and credit card authorisations within two seconds, and monitors the achievement of each of these commitments. The following chart reflects the percentage of IT services meeting and/or exceeding the agreed service targets. Overall results in Europe, Hong Kong and Latin America were each affected by a single month's service issue, which skewed a trend of flat or improving service performance.

*Percentage of IT services meeting or exceeding targets*

### Reconciliation of reported and underlying profit before tax

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HSBC measures its performance internally on a like-for-like basis, eliminating the effects of Group currency translation gains and losses, acquisitions and disposals and gains from the dilution of the Group's interests in associates, which distort the year-on-year comparison. HSBC refers to this as its underlying performance.

The tables below show the underlying performance of HSBC for the year ended 31 December 2007 compared with the year ended 31 December 2006. Comparative information comparing the years ended 31 December 2006 and 2005 is also set out below. Equivalent tables are provided for each of HSBC's customer groups and geographical segments in their respective sections below.

The main differences between HSBC's reported and underlying financial performances were:

- Foreign currency translation differences, mainly due to the weakening of the US dollar, most significantly in Europe due to the size of HSBC's operations in the UK. The Group's profit before tax for 2007 compared with 2006 increased by 10 per cent, of which the effect of the change in foreign currency translation rates accounted for 4 percentage points. The equivalents for 2006 compared with 2005 were 5 per cent and 1 per cent, respectively.
- There were a number of acquisitions and disposals that affected both comparisons. The most significant were the acquisitions of Metris Companies Inc. (Metris) in North America in December 2005; in Latin America, the Argentine operations of Banca Nazionale del Lavoro SpA (Banca Nazionale) in May 2006 and Grupo Banistmo (now HSBC Bank Panama) in November 2006; and HSBC's partner's share in life insurer, Erisa S.A., and property and casualty insurer, Erisa I.A.R.D. (together now renamed HSBC Assurances) in France in March 2007; and the deemed disposals of the stakes in Ping An Insurance (Group) Company of China, Limited (Ping An Insurance), Bank of Communications Limited (Bank of Communications) and Industrial Bank Co. Limited (Industrial Bank), as a consequence of their making share offerings on the domestic A share market in mainland China.



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## Year ended 31 December 2007 compared with year ended 31 December 2006

HSBC	2006	Currency translation <sup>1</sup>	2006	Acquisitions, disposals and dilution	Underlying	2007	Reported	Underlying
	as reported US\$m		exchange rates US\$m			as reported US\$m		
Net interest income	34,486	1,086	35,572	791	1,432	37,795	10	4
Net fee income	17,182	750	17,932	6	4,064	22,002	28	23
Other income <sup>3</sup>	13,698	733	14,431	1,060	3,705	19,196	40	26
<b>Net operating income<sup>4</sup></b>	<b>65,366</b>	<b>2,569</b>	<b>67,935</b>	<b>1,857</b>	<b>9,201</b>	<b>78,993</b>	<b>21</b>	<b>14</b>
Loan impairment charges and other credit risk provisions	(10,573)	(243)	(10,816)	(133)	(6,293)	(17,242)	(63)	(58)
<b>Net operating income</b>	<b>54,793</b>	<b>2,326</b>	<b>57,119</b>	<b>1,724</b>	<b>2,908</b>	<b>61,751</b>	<b>13</b>	<b>5</b>
Operating expenses	(33,553)	(1,536)	(35,089)	(395)	(3,558)	(39,042)	(16)	(10)
<b>Operating profit</b>	<b>21,240</b>	<b>790</b>	<b>22,030</b>	<b>1,329</b>	<b>(650)</b>	<b>22,709</b>	<b>7</b>	<b>(3)</b>
Income from associates	846	20	866	(41)	678	1,503	78	78
<b>Profit before tax</b>	<b>22,086</b>	<b>810</b>	<b>22,896</b>	<b>1,288</b>	<b>28</b>	<b>24,212</b>	<b>10</b>	

## Year ended 31 December 2006 compared with year ended 31 December 2005

HSBC	2005	Currency translation <sup>1</sup>	2005	Acqui- sitions and disposals <sup>2</sup>	Underlying change	2006	Reported change %	Underlying change %
	as reported US\$m		exchange rates US\$m			as reported US\$m		
Net interest income	31,334	263	31,597	605	2,284	34,486	10	7
Net fee income	14,456	159	14,615	263	2,304	17,182	19	16
	11,847	273	12,120	27	1,551	13,698	16	13

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Other income <sup>3</sup>								
Net operating income <sup>4</sup>	57,637	695	58,332	895	6,139	65,366	13	11
Loan impairment charges and other credit risk provisions	(7,801)	(88)	(7,889)	(309)	(2,375)	(10,573)	(36)	(30)
Net operating income	49,836	607	50,443	586	3,764	54,793	10	8
Operating expenses	(29,514)	(392)	(29,906)	(383)	(3,264)	(33,553)	(14)	(11)
Operating profit	20,322	215	20,537	203	500	21,240	5	2
Income from associates	644	10	654	144	48	846	31	7
Profit before tax	20,966	225	21,191	347	548	22,086	5	3

For footnotes, see page 130.



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HSBC HOLDINGS PLC

**Report of the Directors: Business Review** (continued)[Customer groups](#)>[Summary](#)>[Business highlights](#)**Customer groups and global businesses**

## Summary

HSBC manages its business through two customer groups, Personal Financial Services and Commercial Banking, and two global businesses, Global Banking and Markets (previously Corporate, Investment Banking and Markets), and Private Banking.

Personal Financial Services incorporates the Group's consumer finance businesses, reflecting their increasing integration within mainstream financial services around the world. The largest of these is HSBC Finance Corporation (HSBC Finance), one of the leading consumer finance companies in the US.

## Profit before tax

	Year ended 31 December					
	2007		2006		2005	
	US\$m	%	US\$m	%	US\$m	%
Personal Financial Services	5,900	24.4	9,457	42.8	9,904	47.2
Commercial Banking	7,145	29.5	5,997	27.2	4,961	23.7
Global Banking and Markets	6,121	25.3	5,806	26.3	5,163	24.6
Private Banking	1,511	6.2	1,214	5.5	912	4.4
Other <sup>1</sup>	3,535	14.6	(388)	(1.8)	26	0.1
	<b>24,212</b>	<b>100.0</b>	22,086	100.0	20,966	100.0

<sup>1</sup> [Other] includes gains arising from dilution of interests in associates of US\$1,092 million (2006 and 2005: nil) and fair value gains of US\$2,893 million (2006: US\$81 million expense; 2005: US\$406 million income) on HSBC's own debt designated at fair value. The remainder of the Group's gain on own debt is included in Global Banking and Markets.

## Total assets

	At 31 December			
	2007		2006	
	US\$m	%	US\$m	%
Personal Financial Services	588,473	25.0	546,568	29.4

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Commercial Banking	<b>261,893</b>	<b>11.1</b>	213,450	11.5
Global Banking and Markets	<b>1,375,240</b>	<b>58.4</b>	994,436	53.4
Private Banking	<b>88,510</b>	<b>3.8</b>	73,026	3.9
Other	<b>40,150</b>	<b>1.7</b>	33,278	1.8
	<b>2,354,266</b>	<b>100.0</b>	1,860,758	100.0

Basis of preparation

The results are presented in accordance with the accounting policies used in the preparation of HSBC's consolidated financial statements. HSBC's operations are closely integrated and, accordingly, the presentation of customer group data includes internal allocations of certain items of income and expense. These allocations include the costs of certain support services and head office functions, to

the extent that these can be meaningfully attributed to operational business lines. While such allocations have been made on a systematic and consistent basis, they necessarily involve a degree of subjectivity.

Where relevant, income and expense amounts presented include the results of inter-segment funding as well as inter-company and inter-business line transactions. All such transactions are undertaken on arm's length terms.

[Back to Contents](#)**Personal Financial Services**

Profit before tax

	Year ended 31 December		
	2007 US\$m	2006 US\$m	2005 US\$m
Net interest income	29,069	26,076	23,351
Net fee income	11,742	8,762	7,313
Trading income excluding net interest income	38	391	360
Net interest income on trading activities	140	220	214
Net trading income <sup>5</sup>	178	611	574
Net income from financial instruments designated at fair value	1,333	739	574
Gains less losses from financial investments	351	78	19
Dividend income	55	31	16
Net earned insurance premiums	8,271	5,130	4,864
Other operating income	387	782	729
<b>Total operating income</b>	<b>51,386</b>	<b>42,209</b>	<b>37,440</b>
Net insurance claims <sup>6</sup>	(8,147)	(4,365)	(3,716)
<b>Net operating income<sup>4</sup></b>	<b>43,239</b>	<b>37,844</b>	<b>33,724</b>
Loan impairment charges and other credit risk provisions	(16,172)	(9,949)	(7,537)
<b>Net operating income</b>	<b>27,067</b>	<b>27,895</b>	<b>26,187</b>
Total operating expenses	(21,757)	(18,818)	(16,427)
<b>Operating profit</b>	<b>5,310</b>	<b>9,077</b>	<b>9,760</b>
Share of profit in associates and joint ventures	590	380	144
<b>Profit before tax</b>	<b>5,900</b>	<b>9,457</b>	<b>9,904</b>
<b>By geographical region</b>			
Europe	1,581	1,909	1,932
Hong Kong	4,212	2,880	2,628
Rest of Asia-Pacific	760	477	377
North America	(1,546)	3,391	4,181
Latin America	893	800	786
	<b>5,900</b>	<b>9,457</b>	<b>9,904</b>
	%	%	%
Share of HSBC's profit before tax	24.4	42.8	47.2
Cost efficiency ratio	50.3	49.7	48.7

Balance sheet data<sup>7</sup>

	US\$m	US\$m	US\$m
Loans and advances to customers (net)	464,726	448,545	398,884
Total assets	588,473	546,568	484,314
Customer accounts	450,071	388,468	321,240

For footnotes, see page 130.

Strategic direction

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HSBC's strategic direction in Personal Financial Services is to use its global scale and local knowledge to grow profitably in selected markets. The strategy focuses on growth in:

- markets where HSBC has or can build or acquire scale, particularly in Asia-Pacific, Latin America, Turkey and the Middle East;
- markets where HSBC has scale, such as the UK and Hong Kong;
- HSBC Premier customers, who appreciate the benefits of a bank with strong international connectivity; and
- consumer finance, cards, direct banking and other product families where HSBC has global scale and competitive advantages.

### Business highlights in 2007

- Pre-tax profits in Personal Financial Services declined by 38 per cent to US\$5.9 billion in 2007, 41 per cent on an underlying basis. This was due to a US\$6.2 billion increase in loan impairment charges, of which US\$5.2 billion arose in the US, substantially all from the consumer finance business. Excluding US consumer finance, profit before tax increased by 18 per cent, 12 per cent on an underlying basis, driven by exceptionally strong net operating income growth in Asia and, to a lesser extent, Latin America.
- As Asian stock markets grew in value during 2007, HSBC delivered a wider array of products and services to meet demand. The increase in activity was considerable; retail securities transaction volumes in Hong Kong increased by more than 160 per cent and income from investment products in Asia by 150 per cent.
- HSBC Premier (Premier), a global banking and wealth management service for affluent customers, was relaunched in September 2007 with a high-profile advertising campaign. Premier offers a comprehensive and consistent service to customers in 35 markets supported by over 280 international Premier centres. Customer reaction to the relaunch was very positive with a net 340,000 joining the Premier service in 2007, of which more than 50 per cent were new to HSBC. At the end of the year there were more than 2.1 million Premier customers across the Group and gross revenue generated per customer during 2007 averaged in excess of US\$2,000 per year.

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HSBC HOLDINGS PLC

## Report of the Directors: Business Review

(continued)

### *Business highlights*

- HSBC Direct, the Group's online banking and savings offering launched in the US in 2005, continued to grow strongly in 2007. Now also established in Taiwan, South Korea and Canada, HSBC Direct will be introduced into further markets in 2008. In the US, deposits reached US\$11.5 billion from over 620,000 customers, an increase of 60 and 80 per cent, respectively, since the end of 2006. In Asia, over 240,000 customers had deposited US\$1.2 billion by the end of 2007. Additional services were introduced in South Korea in October, including online overdrafts and time deposits. The most recent launch of HSBC Direct was in Canada in June 2007, with an enhanced local online savings account. 45,000 customers, three quarters of whom were new to HSBC, had deposited over US\$800 million by the end of the year.
- The consequences of the downturn in the US housing market, which began in 2006 and accelerated during 2007, continued to affect HSBC's business in North America. It is now clear that the US is experiencing one of the deepest housing market corrections since the Second World War, and the effects have spread beyond their origins in the sub-prime mortgage sector to the wider economy. Restricted refinancing opportunities in a market of falling house prices, negligible investor demand for non-prime asset-backed securities and the tightening of underwriting criteria by lenders will continue to delay any recovery.
- In 2006, HSBC was one of the first lenders in North America to identify a problem in the US mortgage sector. Consequently, in the second half of 2006, HSBC began to contact customers who were facing increased payments on their adjustable-rate mortgages, tighten underwriting criteria and, as credit conditions in the US deteriorated further in 2007, HSBC took the decision to cease correspondent mortgage acquisitions and close Decision One Mortgage Corporation (Decision One), its wholesale business. The size and value of the mortgage services portfolio which encompasses both the wholesale and correspondent businesses, is now decreasing. Weaker credit conditions also affected the consumer lending business and, in the second half of 2007, HSBC stopped underwriting certain products and reduced the branch network to better align it with anticipated demand.
- In 2007, HSBC announced a strategy to accelerate growth in the Group's insurance businesses. The HSBC Insurance brand was launched along with several insurance initiatives across Asia; these are discussed below.
- HSBC's cards in force globally exceeded 120 million at the end of 2007, an increase of 6 per cent. 26 per cent were in emerging markets compared with 20 per cent in 2006, reflecting HSBC's strategic focus there. Around three quarters of HSBC's cards in force are now on a single global system, part of the One HSBC suite of common Group IT systems.
- HSBC continued to expand its consumer finance business in Asia. In India, the Group opened an additional 18 consumer finance branches and loan centres, more than doubling customer numbers. In Indonesia, HSBC opened 36 new consumer finance centres in 2007, taking the total to 64.

### **Europe**

- In the UK, HSBC invested significantly in its distribution network to meet changing customer demands for service. 52 new-style branches were either opened or refurbished in a programme which included both the relocation of branches and the opening of new sites across the country. 25 per cent of all face-to-face customer contact occurred at these new-style branches. This was supported by a significant investment in self-service devices.
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HSBC's focus on innovative competitive liability products, together with consumer confidence in the strength of the HSBC brand, led to a 15 per cent rise in UK average savings balances in 2007.

- In March 2007, HSBC acquired its partner's share of insurer, HSBC Assurances, in France. Integration began in the second half of the year, and there was early evidence of good progress. Sales of life-wrapped investment products increased by 9 per cent year on year, outperforming the market.
- In Turkey, HSBC opened 45 new branches, taking the total to 195. Strong organic growth was driven by excellent customer acquisition, with new customers rising by over 600,000. Encouragingly, the cross-sell ratio continued to improve, driven by a systematic after sale follow-up process.

### **Hong Kong**

- Personal Financial Services had an outstanding year in Hong Kong, with pre-tax profits rising

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by 46 per cent. HSBC provided its customers with an array of products and services, and with the local stock exchange performing strongly in 2007, fee income from investment products grew by 144 per cent and securities turnover by 167 per cent.

- Insurance and retirement products were also a significant driver of growth in Hong Kong. HSBC launched a number of new products during the year and became the leading provider of single-premium life policies.
- As the popularity of internet banking continued in Hong Kong, the proportion of all transactions that were conducted outside the branch network in 2007 was 96 per cent.
- HSBC consolidated its position as the largest credit card issuer in Hong Kong. Cards in force rose by 6 per cent to 4.9 million.

### **Rest of Asia-Pacific**

- In April 2007, HSBC was one of four foreign banks to incorporate in mainland China. This allowed HSBC to start providing a full range of retail banking products, including local currency services to domestic individuals, paving the way for Personal Financial Services to become an increasingly important part of HSBC's business in mainland China.
- HSBC nearly doubled its branch network in mainland China during 2007. The new outlets also included the first ever rural branch opened by a foreign bank. At the end of the year HSBC had more than 80 outlets in mainland China.
- During 2007, HSBC announced several insurance initiatives in India, Vietnam, Taiwan, mainland China, South Korea and the Middle East. HSBC agreed to form a joint venture with two local banks in India, and it entered into an agreement to acquire almost 50 per cent of Hana Life in South Korea. HSBC also acquired 10 per cent of Bao Viet, a leading insurance company in Vietnam. HSBC launched insurance operations in Taiwan and an Islamic insurance business in the Middle East.
- HSBC launched an online savings product in the United Arab Emirates (UAE) at the end of the first quarter of 2007. By the end of the year, almost 10,000 accounts had been opened and more than US\$500 million of deposits placed.

### **North America**

- HSBC continued to address the problems in the US sub-prime mortgage market by contacting, throughout 2007, customers facing increased payments on adjustable-rate mortgages. Since inception of this programme in 2006, HSBC has contacted over 41,000 customers and modified 10,300 loans with a value of US\$1.6 billion. The Group reduced the mortgage services portfolio by US\$13.3 billion in 2007, or 27 per cent, to US\$36.2 billion.
- HSBC Insurance launched a US direct channel at the end of 2006, offering term life insurance directly to consumers, which increased the Group's market share to 7 per cent of annualised premiums.
- HSBC Direct continued to be an effective alternative channel for gathering deposits and reaching new customers, with more than 70 per cent resident outside New York State. By the end of the year, HSBC Direct in the US had attracted US\$11.5 billion of deposits. During 2007, two new complementary products were launched, certificates of deposit and an online payment account.
- The US retail bank opened 26 branches in 2007, taking the total to 465, of which 17 per cent are now outside the bank's original geographic base. The new branches helped aid the growth of Premier in California, Florida and Connecticut.

### **Latin America**

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- HSBC continued to integrate HSBC Bank Panama. Its acquisition in 2006 provided HSBC with access to a market of 83 million people across Central America and northern South America. Investment in re-branding the acquired branch network has begun.
- A buoyant market, combined with attentive customer service and an expanded network in Brazil, helped HSBC gain market share and scale in core products. For example, credit cards in force rose by 28 per cent and, in HSBC Pension Funds, contributions grew by 39 per cent compared with the market average of 23 per cent, positioning HSBC among the top six in the market.

Tu Cuenta, HSBC's packaged account in Mexico, continued to be successful with 1.3 million accounts at the end of 2007, a rise of 29 per cent. Additionally, HSBC increased its market share of credit cards in Mexico by 3.5 percentage points to 10 per cent.



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HSBC HOLDINGS PLC

**Report of the Directors: Business Review**

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*Business highlights*

Reconciliation of reported and underlying profit before tax

**Year ended 31 December 2007 compared with year ended 31 December 2006**

<b>Personal Financial Services</b>	<b>2006 as reported US\$m</b>	<b>Currency translation<sup>1</sup> US\$m</b>	<b>2006 at 2007 exchange rates US\$m</b>	<b>Acquisitions, disposals and dilution gains<sup>2</sup> US\$m</b>	<b>Underlying change US\$m</b>	<b>2007as reported US\$m</b>	<b>Reported change %</b>	<b>Underly cha</b>
Net interest income	26,076	746	26,822	650	1,597	29,069	11	
Net fee income	8,762	322	9,084	(24)	2,682	11,742	34	
Other income <sup>3</sup>	3,006	87	3,093	(91)	(574)	2,428	(19)	
<b>Net operating income<sup>4</sup></b>	<b>37,844</b>	<b>1,155</b>	<b>38,999</b>	<b>535</b>	<b>3,705</b>	<b>43,239</b>	<b>14</b>	
Loan impairment charges and other credit risk provisions	(9,949)	(205)	(10,154)	(72)	(5,946)	(16,172)	(63)	
<b>Net operating income</b>	<b>27,895</b>	<b>950</b>	<b>28,845</b>	<b>463</b>	<b>(2,241)</b>	<b>27,067</b>	<b>(3)</b>	
Operating expenses	(18,818)	(753)	(19,571)	(283)	(1,903)	(21,757)	(16)	
<b>Operating profit</b>	<b>9,077</b>	<b>197</b>	<b>9,274</b>	<b>180</b>	<b>(4,144)</b>	<b>5,310</b>	<b>(42)</b>	
Income from associates	380	13	393	6	191	590	55	
<b>Profit before tax</b>	<b>9,457</b>	<b>210</b>	<b>9,667</b>	<b>186</b>	<b>(3,953)</b>	<b>5,900</b>	<b>(38)</b>	
<b>By geographical region</b>								
Europe	1,909	172	2,081	144	(644)	1,581	(17)	
Hong Kong	2,880	(12)	2,868	□	1,344	4,212	46	
Rest of Asia-Pacific	477	26	503	□	257	760	59	
	3,391	6	3,397	(6)	(4,937)	(1,546)	(146)	

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North America								
Latin America	<b>800</b>	<b>18</b>	<b>818</b>	<b>48</b>	<b>27</b>	<b>893</b>	<b>12</b>	
	<b>9,457</b>	<b>210</b>	<b>9,667</b>	<b>186</b>	<b>(3,953)</b>	<b>5,900</b>	<b>(38)</b>	

Year ended 31 December 2006 compared with year ended 31 December 2005

<b>Personal Financial Services</b>	2005	Currency	2005	Acqui-	Underlying	2006as	Reported	Underlying
	as reported	translation <sup>1</sup>	at 2006 exchange rates	sitions and disposals <sup>2</sup>	change	reported	change	change
	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m	%	%
Net interest income	23,351	252	23,603	560	1,913	26,076	12	8
Net fee income	7,313	78	7,391	247	1,124	8,762	20	15
Other income <sup>3</sup>	3,060	15	3,075	25	(94)	3,006	(2)	(3)
Net operating income <sup>4</sup>	33,724	345	34,069	832	2,943	37,844	12	9
Loan impairment charges and other credit risk provisions	(7,537)	(80)	(7,617)	(301)	(2,031)	(9,949)	(32)	(27)
Net operating income	26,187	265	26,452	531	912	27,895	7	3
Operating expenses	(16,427)	(229)	(16,656)	(347)	(1,815)	(18,818)	(15)	(11)
Operating profit	9,760	36	9,796	184	(903)	9,077	(7)	(9)
Income from associates	144	1	145	157	78	380	164	54
Profit before tax	9,904	37	9,941	341	(825)	9,457	(5)	(8)
By geographical region								
Europe	1,932	24	1,956	(6)	(41)	1,909	(1)	(2)
Hong Kong	2,628	7	2,635	□	245	2,880	10	9
Rest of Asia-Pacific	377	□	377	159	(59)	477	27	(16)
North America	4,181	3	4,184	184	(977)	3,391	(19)	(23)

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Latin America	786	3	789	4	7	800	2	1
	9,904	37	9,941	341	(825)	9,457	(5)	(8)

For  
footnotes,  
see page 130.

[Back to Contents](#)**Commercial Banking**

Profit before tax

	Year ended 31 December		
	2007 US\$m	2006 US\$m	2005 US\$m
Net interest income	9,055	7,514	6,310
Net fee income	3,972	3,207	2,876
Trading income excluding net interest income	265	204	150
Net interest income/ (expense) on trading activities	31	20	(3)
Net trading income <sup>5</sup>	296	224	147
Net income/(expense) from financial instruments designated at fair value	22	(22)	(12)
Gains less losses from financial investments	90	44	9
Dividend income	8	6	9
Net earned insurance premiums	733	258	236
Other operating income	165	250	327
<b>Total operating income</b>	<b>14,341</b>	<b>11,481</b>	<b>9,902</b>
Net insurance claims <sup>6</sup>	(391)	(96)	(118)
<b>Net operating income<sup>4</sup></b>	<b>13,950</b>	<b>11,385</b>	<b>9,784</b>
Loan impairment charges and other credit risk provisions	(1,007)	(697)	(547)
<b>Net operating income</b>	<b>12,943</b>	<b>10,688</b>	<b>9,237</b>
Total operating expenses	(6,252)	(4,979)	(4,453)
<b>Operating profit</b>	<b>6,691</b>	<b>5,709</b>	<b>4,784</b>
Share of profit in associates and joint ventures	454	288	177
<b>Profit before tax</b>	<b>7,145</b>	<b>5,997</b>	<b>4,961</b>
<b>By geographical region</b>			
Europe	2,516	2,234	1,939
Hong Kong	1,619	1,321	955
Rest of Asia-Pacific	1,350	1,034	818
North America	920	957	892
Latin America	740	451	357
	<b>7,145</b>	<b>5,997</b>	<b>4,961</b>
	%	%	%
Share of HSBC's profit before tax	29.5	27.2	23.7
Cost efficiency ratio	44.8	43.7	45.5

Balance sheet data<sup>7</sup>

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	<b>US\$m</b>	US\$m	US\$m
Loans and advances to customers (net)	<b>220,068</b>	172,976	142,041
Total assets	<b>261,893</b>	213,450	175,120
Customer accounts	<b>237,987</b>	190,853	148,106

*For footnotes, see page 130.*

Strategic direction

HSBC's Commercial Banking strategy is focused on two key initiatives:

- to be the leading international business bank, using HSBC's extensive geographical network together with product expertise in payments, trade, receivables finance and foreign exchange to support customers' trading and investing across borders; and
- to be the best bank for small businesses in target markets, building global scale and creating efficiencies by sharing best practices, including in marketing and credit scoring, and selectively rolling-out the direct banking model.

Commercial Banking enhances the customer experience through a strong multi-channel approach to customer relationships, leveraging HSBC's IT platforms and operational processing capabilities. Additional value is captured through strong connectivity with each of the other customer groups.

Business highlights in 2007

- Pre-tax profit increased by 19 per cent to US\$7.1 billion, with considerable growth in both net interest income and net fee income. On an underlying basis, pre-tax profit increased by 13 per cent.
- Growth was driven by strong results in Hong Kong (up by 23 per cent on 2006), mainland China (65 per cent), Mexico (69 per cent) and the UAE (29 per cent). As a result, the share of profits from faster-growing economies increased from 47 per cent in 2006 to 52 per cent in 2007.
- Total customer numbers grew faster than in previous years, by 8 per cent to 2.8 million, driven by growth in the small business segment, particularly in Turkey, Mexico, the UAE, the UK and Hong Kong. The rise in customer numbers helped drive an increase of 25 per cent in deposits, particularly in Hong Kong and the Rest of Asia-Pacific region.
- Lending growth of 27 per cent was also robust, while loan impairment charges remained low at less than 0.5 per cent of average assets.
- Notwithstanding the investment which underpinned the substantial expansion in Asia and Latin America, the cost efficiency ratio was broadly stable at 44.8 per cent. The number of full-time equivalent employees in commercial banking grew by 14 per cent to 26,000, including nearly 7,400 relationship managers.

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HSBC HOLDINGS PLC

## Report of the Directors: Business Review

(continued)

### *Business highlights*

- HSBC continued to improve its capacity to meet customers' cross-border business requirements. International Banking Centres covering a further 38 countries and territories were opened, increasing their coverage to 54 countries and nearly all of the customer base. Customer experience was improved with the launch of SmartForms (electronic account opening forms) in 16 countries, the appointment of specialist corporate international teams in the UK and France and the creation of new country desks in mainland China.
- The effect of these initiatives was demonstrated by growth of 125 per cent in the number of successful referrals through the Global Links system, with aggregate transaction values doubling to US\$6 billion.
- HSBC's success in its strategy to be the best bank for small business was recognised with awards in Hong Kong and the UK for the Business Internet Banking (BIB) platform, and HSBC's service quality was recognised with multiple 'Best Partner' awards in Hong Kong and the top ranking for overall satisfaction in the Canadian Federation of Independent Business survey.
- Direct channel capabilities were improved through the upgrade of BIB platforms in Hong Kong and in six countries in the Rest of Asia-Pacific region, and the enhancement of HSBCnet. A total of 800,000 customers are now active users of BIB, an increase of 24 per cent in 2007, while the number of transactions on HSBCnet grew during the year by 157 per cent to 27 million.
- Commercial Banking continued to make progress in meeting customers' insurance needs with product launches in Hong Kong (FlexiCommercial, Privileged Term and Capital Protection Plan) and the UK (Motor Fleet, Professional Indemnity and High Risk Liability). A number of further projects with strategic partners are currently under development for launch in 2008 in other countries, including Brazil, France and Mexico.
- Commercial Banking continued to grow its cross-referrals to and from other customer groups. In the first half of 2007, over 50 per cent of new small business customers in key markets had existing Personal Financial Services relationships. Referrals of Commercial Banking customers to Private Banking resulted in US\$1.8 billion of assets under management.

Sales of Global Banking and Markets products increased strongly, particularly in treasury products which had revenue increases of over 30 per cent on an underlying basis and more than 50 per cent in Asia.

### **Europe**

- Expansion in Europe continued with the broadening of product capabilities and geographical reach. Receivables Finance was launched in four countries and International Banking Centres in a further seven. Investment continued within Central and Eastern Europe, especially in Poland, where HSBC now offers services in six cities. Following receipt of a retail banking licence in Russia in July 2007, HSBC opened offices in two cities in addition to Moscow.

- In Turkey, rapid expansion continued with the opening of a further 29 branches serving small business customers and the ongoing recruitment of experienced relationship managers. This contributed to a 48 per cent rise in customer numbers, particularly in small and micro businesses. A number of investment banking advisory and structured finance transactions were referred to Global Banking and Markets from Commercial Banking's corporate and mid-market business.
- Further segmentation was applied in the UK with the expansion of multicultural banking, including the UK's first dedicated Polish commercial banking unit. Following the realignment of the relationship management and distribution approach in commercial centres, customer satisfaction improved by 8 percentage points.
- In the UK, 25 per cent more start-up businesses chose HSBC for their banking than in 2006 and nearly a quarter of all new small and micro customers chose Business Direct accounts. Improvements in internet banking led to a 30 per cent increase in the number of users and resulted in recognition from independent surveys for both customer usage and functionality.

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### **Hong Kong**

- HSBC's service excellence was recognised by a number of awards, notably "Best Bank" in the *Euromoney* 2007 Awards for Excellence and "Best SME (small and medium-sized enterprise Partner)" by three organisations.
- HSBC built on its longstanding reputation for trade services with the launch of EasyTrade for the small business segment. Other product launches included FlexiInsurance and Green Equipment Financing.
- The number of SME centres expanded from eight to 10, and there was an increase in the number of dedicated SME relationship managers to nearly 100.
- New functionality was added to BIB, such as forward contract booking and cheque status enquiries. The number of active BIB users increased by 43 per cent and the BIB service was recognised with two awards, the "Best Integrated Corporate Site for Asia" from *Global Finance* 2007 World's Best Internet Banks awards, and the "Best SME e-banking" award from *SMB World* magazine.

### **Rest of Asia-Pacific**

- Trade and payments and cash management revenues grew strongly, particularly in the UAE, India and Vietnam, as HSBC positioned itself in growing economies to benefit from the even faster growth of intra-Asian trade flows. The Greater China regional model was advanced by the acquisition of Chailease Credit Services Company Ltd ("Chailease") in Taiwan, which expanded HSBC's receivables finance business and strengthened both domestic and international trade capabilities. The integration of branches from The Chinese Bank Co., Ltd. ("The Chinese Bank") announced in December 2007, is expected to provide HSBC with a presence in every major city in Taiwan, contributing to the strategy for growth across Greater China.
- In the Middle East, new business banking units were established in the UAE, Bahrain, Jordan, Lebanon, Oman and Qatar, contributing to a 30 per cent growth in customers.
- Cross-sales of investment banking products were strong in India and the Middle East, including *sukuk* deals and two initial public offerings ("IPOs"). HSBC Amanah trade products were introduced in Malaysia.

### **North America**

- In the US, HSBC's payments and cash management services won *Euromoney*'s "Best Cash Management in North America" award for the second year running. The appointment of dedicated resources underpinned strong growth in cross-sales of treasury and debt products to Commercial Banking customers.
- Increased customer segmentation and the reorganisation of branch roles in Canada enabled larger mid-market and real estate relationships to be managed centrally. Combined with product enhancements in the payments and cash management arena, such as six new product launches and functionality improvements across HSBCnet and BIB, Commercial Banking grew strongly. For example, fee income from cross-border payments increased by 27 per cent.

### **Latin America**

- International Banking Centres now provide services to all countries in Latin America, with Mexico providing a regional hub for Central America and Brazil for smaller South American countries.



- In Mexico, trade services revenues increased by 33 per cent and the number of customers grew by 123 per cent. The receivables finance product range was expanded and relaunched using Group IT systems.
- In Brazil, sales of products through electronic and telephone channels increased by 95 per cent, as new products were launched and the number of customers using internet banking rose to 117,000. The Segmento Empreendedor product (local BusinessDirect) was launched in Sao Paulo and Curitiba.

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HSBC HOLDINGS PLC

**Report of the Directors: Business Review**

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*Business highlights*

Reconciliation of reported and underlying profit before tax

**Year ended 31 December 2007 compared with year ended 31 December 2006**

	2006 as reported	Currency translation <sup>1</sup>	2006 at 2007 exchange rates	Acquisitions, disposals and dilution gains <sup>2</sup>	Underlying change	2007as reported	Reported change	Underly cha
	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m	%	
<b>Commercial Banking</b>								
Net interest income	7,514	382	7,896	114	1,045	9,055	21	
Net fee income	3,207	189	3,396	17	559	3,972	24	
Other income <sup>3</sup>	664	27	691	48	184	923	39	
<b>Net operating income<sup>4</sup></b>	<b>11,385</b>	<b>598</b>	<b>11,983</b>	<b>179</b>	<b>1,788</b>	<b>13,950</b>	<b>23</b>	
Loan impairment charges and other credit risk provisions	(697)	(47)	(744)	(61)	(202)	(1,007)	(44)	
<b>Net operating income</b>	<b>10,688</b>	<b>551</b>	<b>11,239</b>	<b>118</b>	<b>1,586</b>	<b>12,943</b>	<b>21</b>	
Operating expenses	(4,979)	(291)	(5,270)	(73)	(909)	(6,252)	(26)	
<b>Operating profit</b>	<b>5,709</b>	<b>260</b>	<b>5,969</b>	<b>45</b>	<b>677</b>	<b>6,691</b>	<b>17</b>	
Income from associates	288	9	297	1	156	454	58	
<b>Profit before tax</b>	<b>5,997</b>	<b>269</b>	<b>6,266</b>	<b>46</b>	<b>833</b>	<b>7,145</b>	<b>19</b>	
<b>By geographical region</b>								
Europe	2,234	196	2,430	□	86	2,516	13	
Hong Kong	1,321	(6)	1,315	□	304	1,619	23	
	1,034	29	1,063	□	287	1,350	31	

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Rest of Asia-Pacific							
North America	957	25	982	□	(62)	920	(4)
Latin America	451	25	476	46	218	740	64
	<u>5,997</u>	<u>269</u>	<u>6,266</u>	<u>46</u>	<u>833</u>	<u>7,145</u>	<u>19</u>

Year ended 31 December 2006 compared with year ended 31 December 2005

	2005 as reported	Currency translation <sup>1</sup>	2005 at 2006 exchange rates	Acqui- sitions and disposals <sup>2</sup>	Underlying change	2006as reported	Reported change	Underlying change
	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m	%	%
<b>Commercial Banking</b>								
Net interest income	6,310	123	6,433	24	1,057	7,514	19	16
Net fee income	2,876	43	2,919	14	274	3,207	12	9
Other income <sup>3</sup>	598	(2)	596	10	58	664	11	10
Net operating income <sup>4</sup>	9,784	164	9,948	48	1,389	11,385	16	14
Loan impairment charges and other credit risk provisions	(547)	(16)	(563)	(7)	(127)	(697)	(27)	(23)
Net operating income	9,237	148	9,385	41	1,262	10,688	16	13
Operating expenses	(4,453)	(80)	(4,533)	(27)	(419)	(4,979)	(12)	(9)
Operating profit	4,784	68	4,852	14	843	5,709	19	17
Income from associates	177	3	180	(6)	114	288	63	63
Profit before tax	4,961	71	5,032	8	957	5,997	21	19
By geographical region								
Europe	1,939	18	1,957	(6)	283	2,234	15	14
Hong Kong	955	(1)	954	□	367	1,321	38	38
Rest of Asia-Pacific	818	7	825	□	209	1,034	26	25
North America	892	30	922	□	35	957	7	4

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Latin America	357	17	374	14	63	451	26	17
	<u>4,961</u>	<u>71</u>	<u>5,032</u>	<u>8</u>	<u>957</u>	<u>5,997</u>	21	19

*For footnotes, see page 130.*

[Back to Contents](#)**Global Banking and Markets**

Profit before tax

	Year ended 31 December		
	2007 US\$m	2006 US\$m	2005 US\$m
Net interest income	4,430	3,168	3,001
Net fee income	4,901	3,718	2,967
Trading income excluding net interest income	3,503	4,890	2,919
Net interest income/ (expense) on trading activities	(236)	(379)	306
Net trading income <sup>5</sup>	3,267	4,511	3,225
Net income from financial instruments designated at fair value	(164)	20	67
Gains less losses from financial investments	1,313	534	475
Dividend income	222	235	79
Net earned insurance premiums	93	73	76
Other operating income	1,218	1,378	1,621
<b>Total operating income</b>	<b>15,280</b>	<b>13,637</b>	<b>11,511</b>
Net insurance claims <sup>6</sup>	(70)	(62)	(54)
<b>Net operating income<sup>4</sup></b>	<b>15,210</b>	<b>13,575</b>	<b>11,457</b>
Loan impairment (charges)/ recoveries and other credit risk provisions	(38)	119	272
<b>Net operating income</b>	<b>15,172</b>	<b>13,694</b>	<b>11,729</b>
Total operating expenses	(9,358)	(7,991)	(6,838)
<b>Operating profit</b>	<b>5,814</b>	<b>5,703</b>	<b>4,891</b>
Share of profit in associates and joint ventures	307	103	272
<b>Profit before tax</b>	<b>6,121</b>	<b>5,806</b>	<b>5,163</b>
<b>By geographical region</b>			
Europe	2,527	2,304	2,114
Hong Kong	1,578	955	922
Rest of Asia-Pacific	2,464	1,649	1,207
North America	(965)	423	573
Latin America	517	475	347
	<b>6,121</b>	<b>5,806</b>	<b>5,163</b>
	%	%	%
Share of HSBC's profit before tax	25.3	26.3	24.6
Cost efficiency ratio	61.5	58.9	59.7

*For footnotes, see page 130.*

Strategic direction

In 2007, the implementation of the "emerging markets-led and financing-focused" strategy was completed and Corporate, Investment Banking and Markets was renamed Global Banking and Markets. HSBC's strategy is to be a leading wholesale bank by:

– utilising HSBC's extensive distribution network;

developing Global Banking and Markets' hub- and-spoke business model; and

continuing to build capabilities in major hubs to support the delivery of an advanced suite of services to corporate, institutional and government clients across the HSBC network.

Ensuring that this combination of product depth and distribution strength meets the needs of existing and new clients will allow Global Banking and Markets to achieve its strategic goals.

#### Business highlights in 2007

- Pre-tax profit increased by 5 per cent to US\$6.1 billion, despite a total of US\$2.1 billion of write-downs on credit trading, leveraged and acquisition financing positions, and monoline credit exposures resulting from disruption and deterioration in the credit markets. In North America, the mortgage-backed securities operation was closed to new business and was downsized. Strong results were reported across most other businesses with record revenues from foreign exchange, equities, securities services, payments and cash management, and HSBC Global Asset Management. Pre-tax profit in Hong Kong, Rest of Asia-Pacific and Latin America rose by 48 per cent. The rise in operating expenses reflected increased volumes in payments and cash management and securities services. On an underlying basis, pre-tax profits were broadly in line with 2006.
- HSBC's leading position in emerging markets and financing was recognised by various industry awards, including being named "Middle East Mergers and Acquisitions Adviser of the Year" and "Middle East Loan House of the Year" by *Acquisitions Monthly* and *International Financing Review*, respectively. In the *Euromoney* 2007 Awards for Excellence, HSBC was named global "Best Risk Management House", "Best Foreign Exchange House in Asia" and, for the tenth consecutive year "Best Risk Management House in Asia".

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HSBC HOLDINGS PLC

**Report of the Directors: Business Review**

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*Business highlights*

Management view of total operating income

	Year ended 31 December		
	2007 US\$m	2006 <sup>9</sup> US\$m	2005 <sup>9</sup> US\$m
Global Markets	<b>5,074</b>	5,533	3,982
Foreign exchange	<b>2,178</b>	1,552	1,233
Credit and Rates	<b>(419)</b>	1,334	947
Structured derivatives	<b>647</b>	874	511
Equities <sup>10</sup>	<b>742</b>	397	336
Securities services	<b>1,926</b>	1,376	955
Global Banking	<b>4,836</b>	3,907	3,437
Financing and capital markets	<b>2,832</b>	2,249	2,179
Payments and cash management	<b>1,632</b>	1,257	907
Other transaction services	<b>372</b>	401	351
Balance sheet management	<b>1,226</b>	713	1,246
HSBC Global Asset Management <sup>11</sup>	<b>1,336</b>	1,066	775
Principal Investments	<b>1,253</b>	686	715
Other <sup>12</sup>	<b>1,555</b>	1,732	1,356
<b>Total operating income</b>	<b>15,280</b>	13,637	11,511

Balance sheet data<sup>7</sup>

## Loans and advances to:

□ customers (net)	<b>250,464</b>	210,220	169,435
□ banks (net)	<b>199,506</b>	156,548	106,123
Total assets	<b>1,375,240</b>	994,436	755,056
Customer accounts	<b>299,879</b>	235,965	202,361
Trading assets, financial instruments designated at fair value, and financial investments	<b>674,647</b>	487,943	373,787
Deposits by banks	<b>126,395</b>	92,954	65,853

*For footnotes, see page 130.*

- In Global Markets, structured derivatives continued to benefit from investment made in technical expertise and systems in previous years, notwithstanding the decline in income from structured credit products. Foreign exchange reported strong growth across all regions. Positive revenue trends reflected higher customer volumes against the backdrop of a weakening US dollar and greater market volatility, particularly in

the second half of 2007. Equities recorded a significant increase especially in Europe and particularly due to HSBC's differentiation in emerging markets products. Securities services benefited from new mandates and increased volumes in higher value products, particularly in Asia, as clients rebalanced their investment portfolios. Assets under custody rose by 30 per cent.

- In Global Banking, the credit market dislocation led to a fair value write-down in respect of loan commitments outstanding when credit spreads widened in the second half of 2007, though robust growth in fees resulting from a greater transaction volume more than offset this. Asset and structured finance also benefited from a small number of significant transactions, while revenues in the capital markets businesses were boosted by greater market activity in Europe and Hong Kong. The continued growth in payments and cash management revenues reflected a rise in deposit balances and higher transaction volumes across most regions.
- HSBC advised on several notable cross-border transactions, including Singapore Telecommunications' US\$758 million acquisition of a 30 per cent stake in Warid Telecom of Pakistan; National Titanium Dioxide of Saudi Arabia's S\$1.2 billion acquisition of Lyondell Chemical's inorganic chemicals business in the US; and Dubai Drydocks' S\$650 million acquisition of Pan-United Marine of Singapore.
- HSBC was lead arranger of US\$9.2 billion of facilities for the acquisition of GE Plastics by Saudi Basic Industries; 2.25 billion for the acquisition of Mölnlycke Health Care by Investor AB; and £3.4 billion for the acquisition of National Grid Wireless by Macquarie.
- In debt capital markets, HSBC ranked first in the Asian local currency bond league table compiled by Bloomberg, first in the sterling bond league table and fifth in the international bond league table.
- The increase in balance sheet management revenues was driven by higher spreads, and arose principally from the recovery in Asia.
- Group Investment Businesses was rebranded as HSBC Global Asset Management following a closer alignment with other businesses within Global Banking and Markets. A rise in income was driven by continuing strong revenue growth from emerging market products across all regions and a notable increase in funds under management. Successes included the development of the global liquidity and multi-manager businesses, established in late 2006 and early 2007, both of which have reported strong inflows of new business. Funds under management rose by 16 per cent to US\$380 billion.
- Principal Investments reported significant gains from a small number of realisations benefiting from higher exit multiples.



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Reconciliation of reported and underlying profit before tax

**Year ended 31 December 2007 compared with year ended 31 December 2006**

	2006 as reported	Currency translation <sup>1</sup>	2006 at 2007 exchange rates	Acquisitions, disposals and dilution gains <sup>2</sup>	Underlying change	2007 as reported	Reported change	Underlying
<b>Global Banking and Markets</b>	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m	%	%
Net interest income	3,168	175	3,343	25	1,062	4,430	40	
Net fee income	3,718	182	3,900	9	992	4,901	32	
Other income <sup>3</sup>	6,689	360	7,049	10	(1,180)	5,879	(12)	
<b>Net operating income<sup>4</sup></b>	<b>13,575</b>	<b>717</b>	<b>14,292</b>	<b>44</b>	<b>874</b>	<b>15,210</b>	<b>12</b>	
Loan impairment (charges)/recoveries and other credit risk provisions	119	6	125	□	(163)	(38)	(132)	
<b>Net operating income</b>	<b>13,694</b>	<b>723</b>	<b>14,417</b>	<b>44</b>	<b>711</b>	<b>15,172</b>	<b>11</b>	
Operating expenses	(7,991)	(406)	(8,397)	(35)	(926)	(9,358)	(17)	
<b>Operating profit</b>	<b>5,703</b>	<b>317</b>	<b>6,020</b>	<b>9</b>	<b>(215)</b>	<b>5,814</b>	<b>2</b>	
Income from associates	103	(4)	99	2	206	307	198	
<b>Profit before tax</b>	<b>5,806</b>	<b>313</b>	<b>6,119</b>	<b>11</b>	<b>(9)</b>	<b>6,121</b>	<b>5</b>	
<b>By geographical region</b>								
Europe	2,304	202	2,506	□	21	2,527	10	
Hong Kong	955	(1)	954	□	624	1,578	65	
Rest of Asia-Pacific	1,649	67	1,716	□	748	2,464	49	
North America	423	21	444	□	(1,409)	(965)	(328)	
Latin America	475	24	499	11	7	517	9	
	<b>5,806</b>	<b>313</b>	<b>6,119</b>	<b>11</b>	<b>(9)</b>	<b>6,121</b>	<b>5</b>	

**Year ended 31 December 2006 compared with year ended 31 December 2005**

	2005 as reported	Currency translation <sup>1</sup>	2005 at 2006 exchange rates	Acquisitions and disposals <sup>2</sup>	Underlying change	2006 as reported	Reported change	Underlying change
<b>Global Banking and Markets</b>	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m	%	%

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Net interest income	3,001	34	3,035	21	112	3,168	6	4
Net fee income	2,967	31	2,998	2	718	3,718	25	24
Other income <sup>3</sup>	5,489	108	5,597	3	1,089	6,689	22	19
Net operating income <sup>4</sup>	11,457	173	11,630	26	1,919	13,575	18	17
Loan impairment recoveries and other credit risk provisions	272	9	281	(1)	(161)	119	(56)	(57)
Net operating income	11,729	182	11,911	25	1,758	13,694	17	15
Operating expenses	(6,838)	(63)	(6,901)	(9)	(1,081)	(7,991)	(17)	(16)
Operating profit	4,891	119	5,010	16	677	5,703	17	14
Income from associates	272	7	279	(4)	(172)	103	(62)	(62)
Profit before tax	5,163	126	5,289	12	505	5,806	12	10
By geographical region								
Europe	2,114	86	2,200	(4)	108	2,304	9	5
Hong Kong	922	2	924	□	31	955	4	3
Rest of Asia-Pacific	1,207	19	1,226	□	423	1,649	37	35
North America	573	14	587	□	(164)	423	(26)	(28)
Latin America	347	5	352	16	107	475	37	30
	5,163	126	5,289	12	505	5,806	12	10

For footnotes, see page 130.

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HSBC HOLDINGS PLC

**Report of the Directors: Business Review**

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*Business highlights***Private Banking**

Profit before tax

	Year ended 31 December		
	2007 US\$m	2006 US\$m	2005 US\$m
Net interest income	1,216	1,011	848
Net fee income	1,615	1,323	1,080
Trading income excluding net interest income	525	362	317
Net interest income on trading activities	9	2	□
Net trading income <sup>5</sup>	534	364	317
Net income/(expense) from financial instruments designated at fair value	(1)	1	(1)
Gains less losses from financial investments	119	166	45
Dividend income	7	5	9
Other operating income	58	61	68
<b>Total operating income</b>	<b>3,548</b>	<b>2,931</b>	<b>2,366</b>
Net insurance claims <sup>6</sup>	□	□	□
<b>Net operating income<sup>4</sup></b>	<b>3,548</b>	<b>2,931</b>	<b>2,366</b>
Loan impairment (charges)/recoveries and other credit risk provisions	(14)	(33)	12
<b>Net operating income</b>	<b>3,534</b>	<b>2,898</b>	<b>2,378</b>
Total operating expenses	(2,025)	(1,685)	(1,466)
<b>Operating profit</b>	<b>1,509</b>	<b>1,213</b>	<b>912</b>
Share of profit in associates and joint ventures	2	1	□
<b>Profit before tax</b>	<b>1,511</b>	<b>1,214</b>	<b>912</b>
<b>By geographical region</b>			
Europe	915	805	539
Hong Kong	305	201	190
Rest of Asia-Pacific	92	80	78
North America	174	114	104
Latin America	25	14	1

	1,511	1,214	912
	%	%	%
Share of HSBC's profit before tax	<b>6.2</b>	5.5	4.4
Cost efficiency ratio	<b>57.1</b>	57.5	62.0
	<b>US\$m</b>	US\$m	US\$m
Balance sheet data <sup>7</sup>			
Loans and advances to customers (net)	<b>43,612</b>	34,297	27,749
Total assets	<b>88,510</b>	73,026	59,827
Customer accounts	<b>106,197</b>	80,303	67,205

*For footnotes, see page 130.*

#### Strategic direction

The strategy for Private Banking is to be one of the world's leading international private banks, by providing excellent client service.

- HSBC's global network and brand provides a base from which Private Banking, working in conjunction with HSBC's other customer groups and global businesses, serves the complex international needs of its clients, utilising traditional and innovative ways of managing and preserving the wealth of high net worth individuals while optimising returns.
- Private Banking aims to grow annuity revenue streams through product leadership in areas such as credit, hedge funds, emerging markets, investment advice and estate planning. This will be achieved by attracting, retaining and motivating talented individuals, by close communication with clients and employees and by increasing expenditure targeted on IT, marketing and brand awareness initiatives. Private Banking's onshore business and intra- group partnerships will also be strengthened.

#### Business highlights in 2007

- Pre-tax profits increased by 24 per cent or 22 per cent on an underlying basis to US\$1.5 billion, primarily due to an outstanding performance in Hong Kong, and strong growth in Switzerland and throughout the Americas.
- Approximately 3,500 inward referrals from other customer groups in HSBC in 2007 resulted in US\$6 billion of net new money. In addition, Global Banking and Markets mandated or completed 34 transactions that originated in Private Banking, on which fees for the Group are expected to be US\$70 million.
- HSBC Private Banking was awarded third best "Global Private Bank" in the *Euromoney* survey, for the third year running.
- Client assets increased by 26 per cent to US\$421.0 billion, of which US\$35.9 billion related to net new money, reflecting strong investment performance and increased marketing expenditure.

[Back to Contents](#)**Client assets**

	<b>2007</b>	2006
	<b>US\$bn</b>	US\$bn
At 1 January	<b>333</b>	273
Net new money	<b>36</b>	34
Value change	<b>19</b>	21
Exchange and other	<b>33</b>	5
	<hr/>	<hr/>
At 31 December	<b>421</b>	333
	<hr/>	<hr/>

**Client assets by investment class**

	<b>2007</b>	2006
	<b>US\$bn</b>	US\$bn
Equities	<b>81</b>	62
Bonds	<b>64</b>	55
Structured products	<b>12</b>	16
Funds	<b>123</b>	83
Cash, fiduciary deposits and other	<b>141</b>	117
	<hr/>	<hr/>
At 31 December	<b>421</b>	333
	<hr/>	<hr/>

- Total client assets, including some non-financial assets held in client trusts, amounted to US\$494.1 billion at 31 December 2007. This represented a 21 per cent increase over the previous year. This measure is equivalent to competitors' assets under management figures.
- In response to client demand, a number of new investment products were launched in 2007 with particular emphasis on private equity in emerging markets. Amanah Investment Solutions, a shariah (Islamic law)-compliant fund, was added to the successful range of multi-manager fund solutions.
- Hedge fund services performed well. HSBC Alternative Investments Ltd successfully launched the HSBC Special Opportunities Fund and earned a number of awards in 2007, including [Hedge Fund of the Year] at the UK Pension Awards, and was shortlisted by the Financial Times as the [Best Client Services] provider.

**Europe**

- Private Banking further expanded its business in the UK and Ireland with offices established in Edinburgh and Dublin, taking the total number of offices in Private Banking to 93.
- Client assets increased by 19 per cent to US\$258.4 billion, of which US\$20.2 billion related to net new money. This was driven by an accumulation of wealth by entrepreneurs in the region, a private banking franchise in most of the major markets and expertise in Switzerland, which remains a centre of excellence for private wealth management.

**Asia**

- Private Banking in Asia had an excellent year in 2007 on the back of strong equity markets, wealth creation in the region and continued recruitment of relationship managers. Client assets increased by 38 per cent to US\$93.0 billion, of which US\$12.9 billion related to net new money.

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- Private Banking clients were significant investors in new offerings from HSBC including the HSBC Multi-Alpha China Fund and HSBC Nan Fung China Infrastructure Fund aimed at taking advantage of strong economic growth in mainland China.
- Onshore private banking in mainland China received regulatory approval in December 2007, and was launched in January 2008. The first branches will be opened in Shanghai, Beijing and Guangzhou.
- A savings product with returns linked to the Hong Kong Stock Exchange (the Forward Accumulator) was introduced by HSBC in Asia.

### **Americas**

- HSBC continued to expand and improve its business in North America. In January 2007, Private Banking services were launched in Canada, since when the business has contributed US\$8 million to Private Banking's pre-tax profits. In addition, a new Private Banking office was opened in Washington.
- A strategic decision was made to exit the Wealth and Tax Advisory Services business in order to focus on core Private Banking activities. The management buyout was completed on 31 December 2007.
- The domestic businesses in Brazil and Mexico experienced strong growth as local entrepreneurs launched IPOs and invested in local markets. The acquisition of HSBC Bank Panama facilitated the establishment of Private Banking operations there.
- As a result of new operations in Canada and Panama and client acquisition by the enlarged franchise in the region, client assets increased by 42 per cent to US\$69.6 billion.

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HSBC HOLDINGS PLC

**Report of the Directors: Business Review**

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*Business highlights*

Reconciliation of reported and underlying profit before tax

**Year ended 31 December 2007 compared with year ended 31 December 2006**

	2006 as reported	Currency translation <sup>1</sup>	2006 at 2007 exchange rates	Acquisitions, disposals and dilution gains <sup>2</sup>	Underlying change	2007 as reported	Reported change	Underlying change
<b>Private Banking</b>	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m	%	
Net interest income	1,011	24	1,035	2	179	1,216	20	
Net fee income	1,323	32	1,355	4	256	1,615	22	
Other income <sup>3</sup>	597	7	604	1	112	717	20	
<b>Net operating income<sup>4</sup></b>	<b>2,931</b>	<b>63</b>	<b>2,994</b>	<b>7</b>	<b>547</b>	<b>3,548</b>	<b>21</b>	
Loan impairment charges and other credit risk provisions	(33)	□	(33)	□	19	(14)	58	
<b>Net operating income</b>	<b>2,898</b>	<b>63</b>	<b>2,961</b>	<b>7</b>	<b>566</b>	<b>3,534</b>	<b>22</b>	
Operating expenses	(1,685)	(40)	(1,725)	(4)	(296)	(2,025)	(20)	
<b>Operating profit</b>	<b>1,213</b>	<b>23</b>	<b>1,236</b>	<b>3</b>	<b>270</b>	<b>1,509</b>	<b>24</b>	
Income from associates	1	□	1	□	1	2	100	
<b>Profit before tax</b>	<b>1,214</b>	<b>23</b>	<b>1,237</b>	<b>3</b>	<b>271</b>	<b>1,511</b>	<b>24</b>	
<b>By geographical region</b>								
Europe	805	22	827	□	88	915	14	
Hong Kong	201	□	201	□	104	305	52	
	80	□	80	□	12	92	15	

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Rest of Asia-Pacific								
North America	114	□	114	□	60	174	53	
Latin America	14	1	15	3	7	25	79	
	<u>1,214</u>	<u>23</u>	<u>1,237</u>	<u>3</u>	<u>271</u>	<u>1,511</u>	<u>24</u>	

Year ended 31 December 2006 compared with year ended 31 December 2005

	2005 as reported	Currency translation <sup>1</sup>	2005 at 2006 exchange rates	Acquisitions and disposals <sup>2</sup>	Underlying change	2006 as reported	Reported change	Underlying change
<b>Private Banking</b>	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m	%	%
Net interest income	848	1	849	□	162	1,011	19	19
Net fee income	1,080	4	1,084	□	239	1,323	23	22
Other income <sup>3</sup>	438	4	442	□	155	597	36	35
Net operating income <sup>4</sup>	2,366	9	2,375	□	556	2,931	24	23
Loan impairment recoveries/ (charges) and other credit risk provisions	12	(1)	11	□	(44)	(33)	(375)	(400)
Net operating income	2,378	8	2,386	□	512	2,898	22	22
Operating expenses	(1,466)	(5)	(1,471)	□	(214)	(1,685)	(15)	(15)
Operating profit	912	3	915	□	298	1,213	33	33
Income from associates	□	□	□	□	1	1	□	□
Profit before tax	912	3	915	□	299	1,214	33	33



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By  
geographical  
region

Europe	539	4	543	□	262	805	49	48
Hong Kong	190	2	192	□	9	201	6	5
Rest of Asia-Pacific	78	(1)	77	□	3	80	3	4
North America	104	(2)	102	□	12	114	10	12
Latin America	1	□	1	□	13	14	1,300	1,300
	<u>912</u>	<u>3</u>	<u>915</u>	<u>□</u>	<u>299</u>	<u>1,214</u>	<u>33</u>	<u>33</u>

For  
footnotes,  
see page 130.

[Back to Contents](#)**Other**

Profit before tax

	Year ended 31 December		
	2007 US\$m	2006 US\$m	2005 US\$m
Net interest expense	(542)	(625)	(472)
Net fee income/(expense)	(228)	172	220
Trading income/(expense) excluding net interest income	127	(228)	(90)
Net interest income/(expense) on trading activities	(1)	82	(13)
Net trading income/(expense) <sup>5</sup>	126	(146)	(103)
Net income/(expense) from financial instruments designated at fair value	2,893	(81)	406
Gains less losses from financial investments	83	147	144
Gains arising from dilution of interests in associates	1,092	□	□
Dividend income	32	63	42
Net earned insurance premiums	(21)	207	260
Other operating income	3,523	3,254	2,634
<b>Total operating income</b>	<b>6,958</b>	<b>2,991</b>	<b>3,131</b>
Net insurance claims <sup>6</sup>	□	(181)	(179)
<b>Net operating income<sup>4</sup></b>	<b>6,958</b>	<b>2,810</b>	<b>2,952</b>
Loan impairment charges and other credit risk provisions	(11)	(13)	(1)
<b>Net operating income</b>	<b>6,947</b>	<b>2,797</b>	<b>2,951</b>
Total operating expenses	(3,562)	(3,259)	(2,976)
<b>Operating profit/(loss)</b>	<b>3,385</b>	<b>(462)</b>	<b>(25)</b>
Share of profit in joint ventures and associates	150	74	51
<b>Profit/(loss) before tax</b>	<b>3,535</b>	<b>(388)</b>	<b>26</b>
<b>By geographical region</b>			
Europe	1,056	(278)	(168)
Hong Kong	(375)	(175)	(178)
Rest of Asia-Pacific	1,343	287	94
North America	1,508	(217)	165
Latin America	3	(5)	113
	<b>3,535</b>	<b>(388)</b>	<b>26</b>
	%	%	%

Share of HSBC's profit before tax	<b>14.6</b>	(1.8)	0.1
Cost efficiency ratio	<b>51.2</b>	116.0	100.8
Balance sheet data <sup>7</sup>			
	<b>US\$m</b>	US\$m	US\$m
Loans and advances to customers (net)	<b>2,678</b>	2,095	1,893
Total assets	<b>40,150</b>	33,278	27,653
Customer accounts	<b>2,006</b>	1,245	507

*For footnotes, see page 130.*

#### Notes

- For a description of the main items reported under "Other", see footnote 8 on page 130.
- Dilution gains of US\$1.1 billion were recorded in the first half of 2007 following share offerings made by three of HSBC's associates: Ping An Insurance, Bank of Communications and Industrial Bank. Although HSBC's holding in these entities was diluted, its share of the capital raised resulted in a gain. Similarly, dilution gains of US\$11 million and US\$5 million were recorded following share issues made by Financiera Independencia, a Mexican banking associate, and Techcombank in Vietnam, respectively.
- Net income from financial instruments designated at fair value of US\$2.9 billion was recorded in 2007, primarily driven by the widening of credit spreads on debt issued by HSBC Holdings and its subsidiaries in North America and Europe, and designated at fair value. These movements will reverse over the life of the debt unless it is repaid before its contractual maturity.
- In 2006, the results of HSBC Insurance Brokers were reported within Other. This contributed US\$591 million to net operating income before loan impairment charges and US\$363 million to operating expenses. In 2007, these results were reallocated to other customer groups.
- The number of countries using Group Service Centres ("GSCs") increased to 31 following the opening of six new centres in 2007. The GSCs now have 30,000 employees in five countries in Asia. Operating expenses at HSBC Technology Services increased by 16 per cent, due to increased demand for services from other Group entities. Substantially all service provider costs are recharged to the relevant customer groups and revenue is reported under "Other operating income".
- HSBC made a US\$73 million gain following a change in the embedded value of HSBC Assurances, an associate in France, prior to the acquisition of its remaining share capital by HSBC.

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HSBC HOLDINGS PLC

**Report of the Directors: Business Review**

(continued)

*Business highlights*

Reconciliation of reported and underlying profit before tax

**Year ended 31 December 2007 compared with year ended 31 December 2006**

Other	2006 as reported US\$m	Currency translation <sup>1</sup> US\$m	2006 at 2007 exchange rates US\$m	Acquisitions, disposals and dilution gains <sup>2</sup> US\$m	Underlying change US\$m	2007 as reported US\$m	Reported change %	Underlying change %
Net interest expense	(625)	(22)	(647)	□	105	(542)	13	
Net fee income/(expense)	172	25	197	□	(425)	(228)	(233)	
Other income <sup>3</sup>	3,263	77	3,340	1,092	3,296	7,728	137	
<b>Net operating income<sup>4</sup></b>	<b>2,810</b>	<b>80</b>	<b>2,890</b>	<b>1,092</b>	<b>2,976</b>	<b>6,958</b>	<b>148</b>	
Loan impairment charges and other credit risk provisions	(13)	3	(10)	□	(1)	(11)	15	
<b>Net operating income</b>	<b>2,797</b>	<b>83</b>	<b>2,880</b>	<b>1,092</b>	<b>2,975</b>	<b>6,947</b>	<b>148</b>	
Operating expenses	(3,259)	(90)	(3,349)	□	(213)	(3,562)	(9)	
<b>Operating profit/(loss)</b>	<b>(462)</b>	<b>(7)</b>	<b>(469)</b>	<b>1,092</b>	<b>2,762</b>	<b>3,385</b>	<b>833</b>	
Income from associates	74	2	76	(50)	124	150	103	
<b>Profit/(loss) before tax</b>	<b>(388)</b>	<b>(5)</b>	<b>(393)</b>	<b>1,042</b>	<b>2,886</b>	<b>3,535</b>	<b>1,011</b>	
<b>By geographical region</b>								
Europe	(278)	(24)	(302)	(50)	1,408	1,056	480	
Hong Kong	(175)	2	(173)	□	(202)	(375)	(114)	
Rest of Asia-Pacific	287	17	304	1,081	(42)	1,343	368	
North America	(217)	□	(217)	□	1,725	1,508	795	
Latin America	(5)	□	(5)	11	(3)	3	160	
	<b>(388)</b>	<b>(5)</b>	<b>(393)</b>	<b>1,042</b>	<b>2,886</b>	<b>3,535</b>	<b>1,011</b>	

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Year ended 31 December 2006 compared with year ended 31 December 2005

	2005 as reported US\$m	Currency translation <sup>1</sup> US\$m	2005 at 2006 exchange rates US\$m	Acqui- sitions and disposals <sup>2</sup> US\$m	Underlying change US\$m	2006 as reported US\$m	Reported change %	Underlying change %
<b>Other</b>								
Net interest expense	(472)	(12)	(484)	□	(141)	(625)	(32)	(29)
Net fee income	220	3	223	□	(51)	172	(22)	(23)
Other income <sup>3</sup>	3,204	13	3,217	(11)	57	3,263	2	2
Net operating income <sup>4</sup>	2,952	4	2,956	(11)	(135)	2,810	(5)	(5)
Loan impairment charges and other credit risk provisions	(1)	□	(1)	□	(12)	(13)	(1,200)	(1,200)
Net operating income	2,951	4	2,955	(11)	(147)	2,797	(5)	(5)
Operating expenses	(2,976)	(15)	(2,991)	□	(268)	(3,259)	(10)	(9)
Operating loss	(25)	(11)	(36)	(11)	(415)	(462)	(1,748)	(1,153)
Income from associates	51	(1)	50	(3)	27	74	45	54
Profit/(loss) before tax	26	(12)	14	(14)	(388)	(388)	(1,592)	(2,771)
By geographical region								
Europe	(168)	(4)	(172)	(14)	(92)	(278)	(65)	(53)
Hong Kong	(178)	(5)	(183)	□	8	(175)	2	4
Rest of Asia-Pacific	94	6	100	□	187	287	205	187
North America	165	1	166	□	(383)	(217)	(232)	(231)
Latin America	113	(10)	103	□	(108)	(5)	(104)	(105)
	26	(12)	14	(14)	(388)	(388)	(1,592)	(2,771)

For footnotes, see page 130.



[Back to Contents](#)**Analysis by customer group and global business**

Profit/(loss) before tax and balance sheet data

Year ended 31 December 2007

<b>Total</b>	<b>Personal Financial Services US\$m</b>	<b>Commercial Banking US\$m</b>	<b>Global Banking &amp; Markets US\$m</b>	<b>Private Banking US\$m</b>	<b>Other<sup>8</sup> US\$m</b>	<b>Inter- segment elimination<sup>14</sup> US\$m</b>	<b>Total US\$m</b>
Net interest income/(expense)	29,069	9,055	4,430	1,216	(542)	(5,433)	37,795
Net fee income/(expense)	11,742	3,972	4,901	1,615	(228)	□	22,002
Trading income excluding net interest income	38	265	3,503	525	127	□	4,458
Net interest income/(expense) on trading activities	140	31	(236)	9	(1)	5,433	5,376
Net trading income <sup>5</sup>	178	296	3,267	534	126	5,433	9,834
Net income/(expense) from financial instruments designated at fair value	1,333	22	(164)	(1)	2,893	□	4,083
Gains less losses from financial investments	351	90	1,313	119	83	□	1,956
Gains arising from dilution of interests in associates	□	□	□	□	1,092	□	1,092
Dividend income	55	8	222	7	32	□	324
Net earned insurance premiums	8,271	733	93	□	(21)	□	9,076
Other operating income	387	165	1,218	58	3,523	(3,912)	1,439
<b>Total operating income</b>	<b>51,386</b>	<b>14,341</b>	<b>15,280</b>	<b>3,548</b>	<b>6,958</b>	<b>(3,912)</b>	<b>87,601</b>
Net insurance claims <sup>6</sup>	(8,147)	(391)	(70)	□	□	□	(8,608)
<b>Net operating</b>	<b>43,239</b>	<b>13,950</b>	<b>15,210</b>	<b>3,548</b>	<b>6,958</b>	<b>(3,912)</b>	<b>78,993</b>

<b>income<sup>4</sup></b>							
Loan impairment charges and other credit risk provisions	<b>(16,172)</b>	<b>(1,007)</b>	<b>(38)</b>	<b>(14)</b>	<b>(11)</b>	□	<b>(17,242)</b>
<b>Net operating income</b>	<b>27,067</b>	<b>12,943</b>	<b>15,172</b>	<b>3,534</b>	<b>6,947</b>	<b>(3,912)</b>	<b>61,751</b>
Total operating expenses	<b>(21,757)</b>	<b>(6,252)</b>	<b>(9,358)</b>	<b>(2,025)</b>	<b>(3,562)</b>	<b>3,912</b>	<b>(39,042)</b>
<b>Operating profit</b>	<b>5,310</b>	<b>6,691</b>	<b>5,814</b>	<b>1,509</b>	<b>3,385</b>	□	<b>22,709</b>
Share of profit in associates and joint ventures	<b>590</b>	<b>454</b>	<b>307</b>	<b>2</b>	<b>150</b>	□	<b>1,503</b>
<b>Profit before tax</b>	<b>5,900</b>	<b>7,145</b>	<b>6,121</b>	<b>1,511</b>	<b>3,535</b>	□	<b>24,212</b>
	%	%	%	%	%		%
Share of HSBC's profit before tax	<b>24.4</b>	<b>29.5</b>	<b>25.3</b>	<b>6.2</b>	<b>14.6</b>		<b>100.0</b>
Cost efficiency ratio	<b>50.3</b>	<b>44.8</b>	<b>61.5</b>	<b>57.1</b>	<b>51.2</b>		<b>49.4</b>
	<b>US\$m</b>	<b>US\$m</b>	<b>US\$m</b>	<b>US\$m</b>	<b>US\$m</b>		<b>US\$m</b>
<b>Balance sheet data<sup>7</sup></b>							
Loans and advances to customers (net)	<b>464,726</b>	<b>220,068</b>	<b>250,464</b>	<b>43,612</b>	<b>2,678</b>		<b>981,548</b>
Total assets	<b>588,473</b>	<b>261,893</b>	<b>1,375,240</b>	<b>88,510</b>	<b>40,150</b>		<b>2,354,266</b>
Customer accounts	<b>450,071</b>	<b>237,987</b>	<b>299,879</b>	<b>106,197</b>	<b>2,006</b>		<b>1,096,140</b>
The following assets and liabilities were significant to Global Banking and Markets:							
loans and advances to banks (net)			<b>199,506</b>				
trading assets, financial assets designated at fair value, and			<b>674,647</b>				



financial  
investments

deposits by  
□banks **126,395**

*For footnotes,  
see page 130.*

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HSBC HOLDINGS PLC

**Report of the Directors: Business Review**

(continued)

*Customer groups > Profit before tax*

Profit/(loss) before tax and balance sheet data (continued)

Year ended 31 December 2006

Total	Year ended 31 December 2006						Total US\$m
	Personal Financial Services US\$m	Commercial Banking US\$m	Global Banking & Markets US\$m	Private Banking US\$m	Other <sup>8</sup> US\$m	Inter- segment elimination <sup>14</sup> US\$m	
Net interest income/(expense)	26,076	7,514	3,168	1,011	(625)	(2,658)	34,486
Net fee income	8,762	3,207	3,718	1,323	172	□	17,182
Trading income/(expense) excluding net interest income	391	204	4,890	362	(228)	□	5,619
Net interest income/ (expense) on trading activities	220	20	(379)	2	82	2,658	2,603
Net trading income/(expense) <sup>5</sup>	611	224	4,511	364	(146)	2,658	8,222
Net income/(expense) from financial instruments designated at fair value	739	(22)	20	1	(81)	□	657
Gains less losses from financial investments	78	44	534	166	147	□	969
Dividend income	31	6	235	5	63	□	340
Net earned insurance premiums	5,130	258	73	□	207	□	5,668
Other operating income	782	250	1,378	61	3,254	(3,179)	2,546
Total operating income	42,209	11,481	13,637	2,931	2,991	(3,179)	70,070
Net insurance claims <sup>6</sup>	(4,365)	(96)	(62)	□	(181)	□	(4,704)
Net operating income <sup>4</sup>	37,844	11,385	13,575	2,931	2,810	(3,179)	65,366
Loan impairment (charges)/ recoveries and other credit risk	(9,949)	(697)	119	(33)	(13)	□	(10,573)

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provisions

Net operating income	27,895	10,688	13,694	2,898	2,797	(3,179)	54,793
Total operating expenses	(18,818)	(4,979)	(7,991)	(1,685)	(3,259)	3,179	(33,553)
Operating profit/(loss)	9,077	5,709	5,703	1,213	(462)	□	21,240
Share of profit in associates and joint ventures	380	288	103	1	74	□	846
Profit/(loss) before tax	9,457	5,997	5,806	1,214	(388)	□	22,086
	%	%	%	%	%		%

Share of HSBC's profit before tax	42.8	27.2	26.3	5.5	(1.8)		100.0
Cost efficiency ratio	49.7	43.7	58.9	57.5	116.0		51.3

	US\$m	US\$m	US\$m	US\$m	US\$m		US\$m
Balance sheet data <sup>7</sup>							
Loans and advances to customers (net)	448,545	172,976	210,220	34,297	2,095		868,133
Total assets	546,568	213,450	994,436	73,026	33,278		1,860,758
Customer accounts	388,468	190,853	235,965	80,303	1,245		896,834

The following assets and liabilities were significant to Global Banking and Markets:

□ loans and advances to banks (net)	156,548
□ trading assets, financial assets designated at fair value, and financial investments	487,943
□ deposits by banks	92,954

For footnotes, see page 130.

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Year ended 31 December 2005

Total	Personal Financial Services US\$m	Commercial Banking US\$m	Global Banking & Markets US\$m	Private Banking US\$m	Other <sup>8</sup> US\$m	Inter- segment elimination <sup>14</sup> US\$m	Total US\$m
Net interest income/(expense)	23,351	6,310	3,001	848	(472)	(1,704)	31,334
Net fee income	7,313	2,876	2,967	1,080	220	□	14,456
Trading income/(expense) excluding net interest income	360	150	2,919	317	(90)	□	3,656
Net interest income/ (expense) on trading activities	214	(3)	306	□	(13)	1,704	2,208
Net trading income/(expense) <sup>5</sup>	574	147	3,225	317	(103)	1,704	5,864
Net income/(expense) from financial instruments designated at fair value	574	(12)	67	(1)	406	□	1,034
Gains less losses from financial investments	19	9	475	45	144	□	692
Dividend income	16	9	79	9	42	□	155
Net earned insurance premiums	4,864	236	76	□	260	□	5,436
Other operating income	729	327	1,621	68	2,634	(2,646)	2,733
Total operating income	37,440	9,902	11,511	2,366	3,131	(2,646)	61,704
Net insurance claims <sup>6</sup>	(3,716)	(118)	(54)	□	(179)	□	(4,067)
Net operating income <sup>4</sup>	33,724	9,784	11,457	2,366	2,952	(2,646)	57,637
Loan impairment (charges)/ recoveries and other credit risk provisions	(7,537)	(547)	272	12	(1)	□	(7,801)
Net operating income	26,187	9,237	11,729	2,378	2,951	(2,646)	49,836
Total operating expenses	(16,427)	(4,453)	(6,838)	(1,466)	(2,976)	2,646	(29,514)
Operating profit/(loss)	9,760	4,784	4,891	912	(25)	□	20,322
Share of profit in associates and joint ventures	144	177	272	□	51	□	644
Profit before tax	9,904	4,961	5,163	912	26	□	20,966

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	%	%	%	%	%	%
Share of HSBC's profit before tax	47.2	23.7	24.6	4.4	0.1	100.0
Cost efficiency ratio	48.7	45.5	59.7	62.0	100.8	51.2
	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m

Balance sheet data<sup>7</sup>

Loans and advances to customers (net)	398,884	142,041	169,435	27,749	1,893	740,002
Total assets	484,314	175,120	755,056	59,827	27,653	1,501,970
Customer accounts	321,240	148,106	202,361	67,205	507	739,419

The following assets and liabilities were significant to Global Banking and Markets:

□ loans and advances to banks (net)			106,123			
□ trading assets, financial assets designated at fair value, and financial investments			373,787			
□ deposits by banks			65,853			

For footnotes, see page 130.

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HSBC HOLDINGS PLC

**Report of the Directors: Business Review** (continued)*Geographical regions>Summary>Competitive environment***Geographical regions**

## Summary of geographical regions

In the analysis of profit by geographical regions that follows, operating income and operating expenses include intra-HSBC items of US\$1,985 million (2006: US\$1,494 million; 2005: US\$938 million).

## Profit before tax

Year ended 31 December

	2007		2006		2005	
	US\$m	%	US\$m	%	US\$m	%
Europe	<b>8,595</b>	<b>35.5</b>	6,974	31.5	6,356	30.3
Hong Kong	<b>7,339</b>	<b>30.3</b>	5,182	23.5	4,517	21.5
Rest of Asia-Pacific	<b>6,009</b>	<b>24.8</b>	3,527	16.0	2,574	12.3
North America	<b>91</b>	<b>0.4</b>	4,668	21.1	5,915	28.2
Latin America	<b>2,178</b>	<b>9.0</b>	1,735	7.9	1,604	7.7
	<b>24,212</b>	<b>100.0</b>	22,086	100.0	20,966	100.0

Total assets<sup>7</sup>

At 31 December

	2007		2006	
	US\$m	%	US\$m	%
Europe	<b>1,184,315</b>	<b>50.3</b>	828,701	44.6
Hong Kong	<b>332,691</b>	<b>14.1</b>	272,428	14.6
Rest of Asia-Pacific	<b>228,112</b>	<b>9.7</b>	167,668	9.0
North America	<b>510,092</b>	<b>21.7</b>	511,190	27.5
Latin America	<b>99,056</b>	<b>4.2</b>	80,771	4.3
	<b>2,354,266</b>	<b>100.0</b>	1,860,758	100.0

For footnote, see page 130.

Additional information on results in 2007 may be found in the [Report of the Directors: Financial Review] on pages 131 to 191.

Europe

HSBC's principal banking operations in Europe are HSBC Bank plc ("HSBC Bank") in the UK, HSBC France, HSBC Bank A.S. in Turkey, HSBC Bank Malta p.l.c., HSBC Private Bank (Suisse) S.A., HSBC Trinkaus & Burkhardt AG and HSBC Gyuertzeller Bank AG. Through these operations HSBC provides a wide range of banking, treasury and financial services to personal, commercial and corporate customers across Europe.

#### Hong Kong

HSBC's principal banking subsidiaries in Hong Kong are The Hongkong and Shanghai Banking Corporation Limited ("The Hongkong and Shanghai Banking Corporation") and Hang Seng Bank Limited ("Hang Seng Bank"). The former is the largest bank incorporated in Hong Kong and is HSBC's flagship bank in the Asia-Pacific region. It is one of Hong Kong's three note-issuing banks, accounting for more than 65 per cent by value of banknotes in circulation in 2007.

#### Rest of Asia-Pacific (including the Middle East)

HSBC offers personal, commercial, global banking and markets services in mainland China, mainly through its local subsidiary, HSBC Bank (China) Company Limited ("HSBC Bank China"), which was incorporated in March 2007. The bank's network spans 18 major cities, comprising 18 branches and 44 sub-branches. Hang Seng Bank offers personal and commercial banking services and operates 10 branches, 14 sub-branches and one representative office in 10 cities in mainland China. HSBC also participates indirectly in mainland China through its three associates, Bank of Communications (19.01 per cent owned), Ping An Insurance (16.78 per cent) and Industrial Bank (12.78 per cent), and has a further interest of 8 per cent in Bank of Shanghai.

Outside Hong Kong and mainland China, HSBC conducts business in 21 countries in the Asia-Pacific region, primarily through branches and subsidiaries of The Hongkong and Shanghai Banking Corporation, with particularly strong coverage in India, Indonesia, South Korea, Singapore and Taiwan. HSBC's presence in the Middle East is led by HSBC Bank Middle East Limited ("HSBC Bank Middle East"), whose network of branches,

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subsidiaries and associates has the widest coverage in the region; in Australia by HSBC Bank Australia Limited; and in Malaysia by HSBC Bank Malaysia Berhad (HSBC Bank Malaysia), which is the largest foreign-owned bank in the country by operating income and pre-tax profits. HSBC's associate in Saudi Arabia, The Saudi British Bank (40 per cent owned), is the Kingdom's sixth largest bank by total assets.

#### North America

HSBC's North American businesses are located in the US, Canada and Bermuda. Operations in the US are primarily conducted through HSBC Bank USA, N.A. (HSBC Bank USA) which is concentrated in New York State, and HSBC Finance, a national consumer finance company based in Chicago. HSBC Markets (USA) Inc. is the intermediate holding company of, *inter alia*, HSBC Securities (USA) Inc., a registered broker and dealer of securities and a registered futures commission merchant. HSBC Bank Canada and The Bank of Bermuda Limited (Bank of Bermuda) operate in their respective countries.

#### Latin America

HSBC's operations in Latin America and the Caribbean principally comprise HSBC México, S.A. (HSBC Mexico), HSBC Bank Brasil S.A.-Banco Múltiplo (HSBC Bank Brazil), HSBC Bank Argentina S.A. (HSBC Bank Argentina) and HSBC Bank (Panama) S.A. (HSBC Bank Panama), formerly Grupo Banistmo S.A., which owns subsidiaries in Costa Rica, Honduras, Colombia, Nicaragua and El Salvador. HSBC is also represented by subsidiaries in Chile, the Bahamas, Peru, Paraguay and Uruguay and by a representative office in Venezuela. In addition to banking services, HSBC operates insurance businesses in Mexico, Argentina, Brazil, Panama, Honduras and El Salvador. In Brazil, HSBC offers consumer finance products through its subsidiary, Losango.

### Competitive environment

HSBC believes that open and competitive markets are good for both local economies and their participants. The Group faces very strong competition in the markets it serves. In personal and commercial banking, it competes with a wide range of institutions including commercial banks, consumer finance companies, retail financial service companies, savings and loan associations, credit unions, general retailers, brokerage firms and investment companies. In investment banking,

HSBC faces competition from specialist providers and the investment banking operations of other commercial banks.

Regulators routinely monitor and investigate the competitiveness of the financial services industry (of which HSBC is a part) in a number of areas, particularly in the UK and continental Europe. HSBC's policy is to co-operate and work positively with all its regulators, providing data and perspective on those issues which affect all financial service providers both directly and through industry bodies.

#### Global factors

### Market liquidity

The "credit crunch" disruption in credit markets that began in the latter half of 2007 is resulting in the movement of assets back on to banks' balance sheets, absorbing capital and constraining banks' ability to lend. The disruption has created an imbalance between the supply and demand for many classes of financial assets and has led to the traditional buyers of debt adopting a very cautious approach to the purchase of any securities which are neither fully transparent in risk profile nor of assured liquidity. Although this liquidity strain began in the asset-backed securities markets, it has since spread to more traditional investment classes. In this environment, the scope for a bank to originate assets beyond its capacity to hold them to term is limited by its available capital and funding resources. This environment is less disruptive to banks that fund their lending through deposits than those that rely on the securitisation markets for funding.

### Progressive alignment of the capital adequacy framework towards economic capital



As major banks move to the new Basel II capital adequacy framework (see "Basel II" on page 284), their capital requirements will necessarily be more closely matched with their risk profiles. In an environment of economic uncertainty, many banks may need to reduce lending due to forecast increases in capital requirements arising from deterioration in the quality of their credit risk exposures. This reduction in risk appetite may potentially accelerate the deterioration in credit quality as credit availability is restricted during a downturn in the economic cycle. When coupled with a lack of market liquidity, this may lead to polarisation within the banking system. Banks with greater capital and liquidity resources are better placed to meet the ongoing banking requirements of their customers than other banks which are more constrained in this regard.

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## **Report of the Directors: Business Review**

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### *Competitive environment*

#### **Advances in technology**

Customer transaction volumes continue to grow at a rate considerably ahead of the growth in underlying balances or accounts, leading many banks to seek to reduce unit costs per service transaction in order to maintain margins. The deployment of automated secure transaction channels requires significant investment, providing a competitive advantage to banks with larger scale. Despite widespread adoption by both banks and customers of new distribution channels, the expected reduction in volumes of transactions through traditional channels has been slow to materialise and many banking customers continue to prefer to use them. The younger generation of customers, however, tends to be more comfortable with system-aided self-service, particularly for savings accounts, credit cards and simple investments. HSBC expects the sophistication of products sold in direct channels and adoption rates to increase, as the use of 24-hour self-service channels, such as ATMs, internet, mobile, and voice response units becomes increasingly commonplace.

#### **Regulation**

Initiatives such as Basel II, together with the increasingly international scope of financial services, have raised the level of cooperation between regulatory authorities in different countries. Enhanced understanding of how risks are originated and dispersed in modern financial markets has reinforced the need to address how best to regulate the increasingly integrated and international nature of banking and financial services; this has been evidenced most recently in coordinated discussions on the global liquidity disruption. In addition, the enlargement of the EU, the introduction of the Markets in Financial Instruments Directive (MIFID) and the continued effort to endorse consistent standards and enforcement has encouraged regulatory bodies to work together more closely. Interaction and cooperation have led to competitive and regulatory issues emerging in one country rapidly being taken up in other jurisdictions. Uniform global standards, however, continue to be complicated by differing local interpretations, or additional local regulation.

#### Regional factors

##### **Europe**

Across Europe, in all sectors, HSBC competes with a growing range of institutions. These markets are characterised by rapid innovation, margin compression through competition and a constant flow of new entrants. Regulators monitor the financial services sector closely and conduct reviews

into the long-term evolution of the industry. Legislators are enforcing legislation with the aim of improving competition and protecting consumers.

In November 2007, the European Commission announced that in order to improve the competitiveness and efficiency of European retail financial services markets, reviews would be undertaken to improve customer choice and mobility within the single market; better facilitate retail insurance markets; achieve progress towards adequate and consistent rules for the distribution of retail investment products; and promote financial education, financial inclusion and adequate redress for consumers.

Following a long running investigation, the Competition Directorate-General determined that MasterCard's multilateral interchange fees for cross-border payment card transactions violate EU competition rules. MasterCard has six months to comply or respond. HSBC is fully engaged in the case through its membership of MasterCard.

A number of key EU measures intended to facilitate development of the single market and increase competition came into effect during the year; principally, transposition of the Markets in Financial Instruments Directive in November 2007. Implementation of phase 1 of the Single Euro Payments Area programme occurred in January 2008.

*UK*

Financial services, including retail banking, is a highly competitive sector in the UK, led by several national and international institutions which compete on both price and service quality. Domestic acquisitions or mergers are limited. The sector is closely regulated, and a series of investigations with particular relevance to Personal Financial Services remain in progress.

In July 2007, a group of seven banks (including HSBC) and one building society announced that they had agreed with the Office of Fair Trading (OFT) that the legal status and enforceability of certain of the charges applied to their personal customers in relation to unauthorised overdrafts should be tested in the High Court. Certain preliminary issues in the case came before the High Court in a trial starting in January 2008 and this part of the case concluded in February 2008. At the date of this report, judgement in the case is awaited. The OFT is also conducting a market study into competition for personal current accounts.

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The Competition Commission (["CC"]) commenced an investigation into the payment protection insurance (["PPI"]) market in February 2007 and published its Emerging Thinking document in November 2007. Provisional findings are due in May 2008 and the final report towards the end of the year. Similarly, the Financial Services Authority (["FSA"]) conducted the third phase of its review of the sales processes and systems around the sale of PPI policies and is now undertaking further assessment of firms' performance in this area.

In December 2007, the CC announced its decision to lift the price controls imposed in 2003 on HSBC and the other three largest banks providing services to small and medium-sized enterprises in the UK. This is expected to result in greater competition and innovation within the market.

During 2007, the OFT continued to investigate competition issues in connection with the setting of multilateral interchange fees for domestic credit card payments.

*France*

In 2007, interest rates in the eurozone increased while growth in real estate investment stabilised. Income tax relief on new personal real estate loans was introduced following the presidential elections, though potential benefits to customers were offset by higher interest rates. Real estate mortgage loans remained the primary product by which banks attracted new customers and, as a result, competitive pricing led to decreased margins.

The French government introduced various fiscal incentives in the second half of 2007 which reduced tax on overtime pay and introduced a cap on the total tax paid by households at 50 per cent of income. These measures increased the disposable income of wealthier individuals who qualify for HSBC Premier and Private Banking services.

The commercial treasury bills market contracted and companies had difficulty obtaining facilities in the second half of 2007 due to market uncertainty. This trend is expected to continue in 2008.

**Hong Kong**

The lending market remained active in 2007, initially driven by investment-related loans and, subsequently, as interest rates declined and market uncertainty increased, by property loans. A robust labour market and rising household wealth supported growth in consumer spending. As a result, demand for personal loans and credit cards rose.

In the middle of 2007, downward pressure on interest rates and an overall improvement in the property market led to increased demand for mortgages. Prices for high-end properties rose, though competition in traditional mortgage products remained fierce.

Rising equity markets stimulated sales of investment products and related loans. After a lull in demand in August and September, when disruption to money markets intensified as the implications for asset-backed securities of the growing credit crisis were reassessed, the market experienced intense volatility, accentuated by the possibility of a recession in the US.

Funds were attracted to Hong Kong during the year in anticipation of sustained appreciation of the renminbi as well as a positive outlook for the mainland Chinese stocks listed in Hong Kong. Deposit growth remained robust throughout the year and the status of Hong Kong as the chief financial centre to service the needs of businesses in Southern China was enhanced.

**Rest of Asia-Pacific**

*(including the Middle East)*

The business environment in the region remained highly competitive, notwithstanding increased demand for credit in Asian countries partially resulting from lower interest rates. In particular, short-term interest rates in mainland China, India, Indonesia, Malaysia and Singapore were less than the nominal Gross Domestic Product (["GDP"]) growth rate.

*Mainland China*

The People's Bank of China indicated that it would continue to apply tight monetary policy to address excess domestic liquidity, to curb lending and to strengthen macro-economic conditions. Loan growth in mainland China remained robust despite this tightening and the benchmark one-year lending rate increased to 7.47 per cent by the end of 2007. The renminbi reserve requirement ratio for depository financial institutions increased to 14.5 per cent.

*India*

Loan growth in 2007 slowed due to earlier monetary tightening and adverse regulatory policies which restricted the activities of recovery agents. Aggressive growth strategies by several banks compressed margins and reduced overall asset quality.

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### *Competitive environment*

#### *Middle East*

The competitive environment in the Middle East intensified during 2007 as the regional economy prospered on the back of record oil prices, which prompted a surge in infrastructure development and construction activities. The Dubai International Finance Centre and the Qatar Financial Centre continued to attract a number of international institutions to set up operations in the region, particularly in the investment and private banking sectors.

Islamic banking activities continued to grow as a percentage of the market with the establishment of two prominent banks during the year. A number of competitor banks introduced innovative products and launched reward programmes to attract and retain customers.

#### *Malaysia, South Korea, Indonesia and Taiwan*

Competition in the Malaysian banking sector remained high as average lending rates continued to decline, despite no change to central bank policy. Banks in South Korea faced increased funding costs as they competed for deposits with securities firms who offered competitive rates on cash management accounts. Measures to cool the real estate sector also resulted in deterioration of asset quality for loans associated with real estate and construction. Loan growth in Indonesia increased in late 2007, as the central bank of Indonesia continued to ease monetary policy. In Taiwan, loan demand increased in 2007 although it remained relatively low.

### **North America**

#### *US*

The Group's principal US subsidiaries, HSBC Bank USA and HSBC Finance, faced unprecedented shifts and uncertainties in the credit environment as the US housing market continued to deteriorate. This precipitated significant changes in the competitor landscape.

Increased payments on resetting adjustable-rate mortgages (ARMs), together with falling house prices, led to turmoil in the mortgage industry as deteriorating credit quality led to a loss of appetite among buyers of securitised mortgages in the secondary market. The contraction of this important funding source undermined the business models of many market participants and over 100 competitors closed, declared bankruptcy or were taken over in 2007. Influences on the market for securitised mortgages had consequential effects on broader credit markets and resulted in a general tightening

of credit availability, with particular impact on financial institutions exposed to sub-prime residential mortgages. Illiquidity in the markets for related credit derivatives impacted the valuation of such instruments.

The remaining sub-prime mortgage providers tightened underwriting standards and increased rates to reduce volumes, as they were obligated to retain originated loans. Previously, most of these loans had been packaged and sold to third party investors on the secondary market. Major market participants acted to reduce the number of foreclosures resulting from ARMs by offering modified loan terms to customers in financial distress. These initiatives were supported and encouraged by federal and state regulators. HSBC was one of the first institutions to take a lead in this respect.

Regulatory scrutiny of the credit card industry increased in 2007 and, although no new major legislation was announced, a number of institutions, including HSBC, amended credit card terms and changed certain charging practices, benefiting customers but at a cost to lenders. Notwithstanding this, credit card competition remained fierce throughout 2007, with the launch of a number of innovative new products including environmentally-themed initiatives and online substitutes for traditional cards.

*Canada*

In Canada, the six largest banks retained their significant presence in the country's financial services industry. Markets remained competitive, however, with largely equivalent products being offered by banks, insurance companies and other financial institutions. Canadian financial markets felt the effects of the downturn in US residential property markets as certain asset-backed commercial paper conduits experienced difficulty funding their obligations. A group of Canadian and international banks established accords to support these vehicles.

**Latin America**

*Mexico*

In Mexico, the banking industry remained centred around the five largest institutions (including HSBC), which control 80 per cent of the banking system's assets. Penetration of the formal financial system remained low compared with other developing economies in the region, while demographics indicated a young and growing population. Bank financing to the private sector was less than 20 per cent of GDP, indicating significant room for growth. In this context, the overall banking

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system continued to expand credit rapidly and loan growth has exceeded 20 per cent per annum over the last two years.

In 2007, eight new banking licences were granted and over 350 non-bank intermediaries entered the consumer market. An amendment to legislation late in 2007 granted specialised banking licenses with reduced regulatory requirements. This is expected to further boost competitive forces.

Mexican banks faced additional legislation with the imposition of tariff restrictions on deposit account fees and ATM commissions. HSBC continued to increase its market share in core consumer, commercial and corporate banking products, and sought to differentiate itself through customer service. HSBC is well positioned to capitalise on economic growth with its extensive branch and ATM network.

*Central America*

HSBC has financial services operations in Panama, El Salvador, Costa Rica, Honduras, Colombia and Nicaragua. Central America's banking industry has attracted significant foreign investment in recent years due to its expanding domestic economies. In the last two years, a number of international groups established major retail banking operations through a series of purchases. In El Salvador and Costa Rica, foreign banks and local governments own the majority of banking institutions. Panama, Honduras and Guatemala continued to be served by several large, independent domestic banking institutions.

International banks operating in Central America increased their presence and, hence, the availability of reliable financing sources. These banks are also expected to accelerate the adoption of improved corporate and risk management practices in the region, together with a more efficient allocation of resources.

*Brazil*

In Brazil, the top ten banking groups accounted for 71 per cent of banking assets and 87 per cent of branches, unchanged from 2006. These groups include local state-owned banks, privately-owned banks and large foreign banks (including HSBC). Privately-owned banks continued to grow their market share (from 57 per cent in 2006 to 62 per cent in 2007), through consolidation and growth in credit operations, due to the positive economic conditions. Further consolidation took place when Banco Santander acquired Banco Real as part of the successful consortium bid for ABN Amro.

Total lending as a percentage of GDP was 35 per cent, remaining relatively low by international standards. Improved access to financial services and increased participation in the formal economy indicate the potential for further growth in the financial services sector.

*Argentina*

International financial groups and local banks with largely equivalent product and service offerings formed HSBC's major competition in Argentina.



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*Europe >2007***Europe**

Profit/(loss) before tax by country within customer groups and global businesses

	<b>Personal Financial Services US\$m</b>	<b>Commercial Banking US\$m</b>	<b>Global Banking &amp; Markets<sup>13</sup> US\$m</b>	<b>Private Banking US\$m</b>	<b>Other US\$m</b>	<b>Total US\$m</b>
<b>Year ended 31 December 2007</b>						
United Kingdom	1,221	2,064	1,214	317	976	5,792
France <sup>15</sup>	173	192	692	25	(49)	1,033
Germany	□	36	195	45	19	295
Malta	45	67	45	□	□	157
Switzerland	□	□	□	475	□	475
Turkey	144	75	118	(1)	□	336
Other	(2)	82	263	54	110	507
	<b>1,581</b>	<b>2,516</b>	<b>2,527</b>	<b>915</b>	<b>1,056</b>	<b>8,595</b>
<b>Year ended 31 December 2006</b>						
United Kingdom	1,496	1,801	1,299	380	(185)	4,791
France <sup>15</sup>	174	236	545	22	(107)	870
Germany	□	29	114	41	16	200
Malta	42	50	29	□	□	121
Switzerland	□	□	□	305	□	305
Turkey	121	50	64	□	(18)	217
Other	76	68	253	57	16	470
	<b>1,909</b>	<b>2,234</b>	<b>2,304</b>	<b>805</b>	<b>(278)</b>	<b>6,974</b>
<b>Year ended 31 December 2005</b>						
United Kingdom	1,475	1,495	1,186	171	(47)	4,280
France <sup>15</sup>	223	278	472	7	(147)	833
Germany	□	42	131	48	16	237
Malta	29	46	31	□	□	106
Switzerland	□	□	□	254	□	254
Turkey	134	39	92	□	□	265
Other	71	39	202	59	10	381
	<b>1,932</b>	<b>1,939</b>	<b>2,114</b>	<b>539</b>	<b>(168)</b>	<b>6,356</b>

Loans and advances to customers (net) by country

	Year ended 31 December		
	2007 US\$m	2006 US\$m	2005 US\$m
United Kingdom	<b>326,927</b>	305,758	245,004
France <sup>15</sup>	<b>81,473</b>	55,491	43,772
Germany	<b>6,411</b>	4,439	3,349
Malta	<b>4,157</b>	3,456	2,794
Switzerland	<b>13,789</b>	9,151	7,312
Turkey	<b>7,974</b>	5,233	3,787
Other	<b>11,544</b>	8,971	6,519
	<b>452,275</b>	392,499	312,537

*For footnotes, see page 130.*

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## Customer accounts by country

	Year ended 31 December		
	2007 US\$m	2006 US\$m	2005 US\$m
United Kingdom	367,363	318,614	246,723
France <sup>15</sup>	64,905	43,372	39,359
Germany	10,282	11,607	8,393
Malta	5,947	4,529	3,760
Switzerland	41,015	30,062	26,984
Turkey	6,473	4,140	3,493
Other	8,969	7,041	5,488
	<b>504,954</b>	<b>419,365</b>	<b>334,200</b>

## Profit before tax

	Year ended 31 December		
	2007 US\$m	2006 US\$m	2005 US\$m
<b>Europe</b>			
Net interest income	7,746	8,289	8,221
Net fee income	8,431	7,108	6,299
Net trading income	6,943	4,529	3,036
Net income from financial instruments designated at fair value	1,226	144	362
Gains less losses from financial investments	1,326	624	439
Dividend income	171	183	63
Net earned insurance premiums	4,010	1,298	1,599
Other operating income	1,193	1,428	1,603
<b>Total operating income</b>	<b>31,046</b>	<b>23,603</b>	<b>21,622</b>
Net insurance claims incurred and movement in liabilities to policyholders .	(3,479)	(531)	(818)
<b>Net operating income before loan impairment charges and other credit risk provisions</b>	<b>27,567</b>	<b>23,072</b>	<b>20,804</b>
Loan impairment charges and other credit risk provisions	(2,542)	(2,155)	(1,929)
<b>Net operating income</b>	<b>25,025</b>	<b>20,917</b>	<b>18,875</b>
Total operating expenses	(16,525)	(13,871)	(12,639)
<b>Operating profit</b>	<b>8,500</b>	<b>7,046</b>	<b>6,236</b>
Share of profit/(loss) in associates and joint ventures	95	(72)	120
<b>Profit before tax</b>	<b>8,595</b>	<b>6,974</b>	<b>6,356</b>
	%	%	%
Share of HSBC's profit before tax	35.5	31.5	30.3

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Cost efficiency ratio	<b>59.9</b>	60.1	60.8
Year-end staff numbers (full-time equivalent)	<b>82,166</b>	78,311	77,755

Balance sheet data<sup>7</sup>

	At 31 December		
	<b>2007</b>	2006	2005
	<b>US\$m</b>	US\$m	US\$m
Loans and advances to customers (net)	<b>452,275</b>	392,499	312,537
Loans and advances to banks (net)	<b>104,527</b>	76,830	44,360
Trading assets, financial instruments designated at fair value and financial investments <sup>16</sup>	<b>445,258</b>	242,010	146,777
Total assets	<b>1,184,315</b>	828,701	636,703
Deposits by banks	<b>87,491</b>	67,821	47,202
Customer accounts	<b>504,954</b>	419,365	334,200

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Europe &gt;2007

Year ended 31 December 2007 compared with year ended 31 December 2006

**Economic briefing**

In the **UK**, GDP growth accelerated in 2007 to 3.1 per cent from 2.9 per cent in 2006, mainly as a result of buoyant consumer and investment spending. Net trade depressed GDP growth through 2007, and the current account deficit reached a record 5.7 per cent of GDP in the third quarter of the year. Employment growth was fairly subdued, rising by approximately 0.7 per cent during the year. Consumer Price Index (CPI) inflation reached a decade-long high of 3.1 per cent in March but subsequently fell back to 2.1 per cent by the year-end, close to the Bank of England's 2 per cent target. After a strong start to the year, nominal house prices declined and housing activity diminished in the final months of 2007. The Bank of England raised interest rates by 75 basis points during 2007 to a peak of 5.75 per cent, but subsequently reduced them to 5.5 per cent at the end of 2007.

The expansion of the **eurozone** economy continued steadily in 2007, with GDP growth of 2.7 per cent. As in the UK, much of the momentum

came from strength in business investment and exports as global demand remained strong, particularly from emerging markets. Consumption was relatively subdued, despite declining unemployment, although fiscal reforms (particularly in Germany) are believed to have depressed household expenditure. Eurozone inflation increased steadily during the second half of the year to an annual rate of 3.1 per cent in December, driven largely by rises in food and energy prices. The European Central Bank (ECB) raised interest rates by 50 basis points during 2007, to finish the year at 4 per cent.

In **Turkey**, economic activity softened as the year progressed, with GDP rising by 3.9 per cent during the first three quarters of 2007 against the comparable period of 2006. Headline inflation remained under pressure from increases in energy and food prices, though core indicators improved markedly, prompting Turkey's central bank to cautiously ease monetary policy. The current account deficit stabilised at about 7 per cent of GDP with rising service sector receipts from tourism, although high energy costs may cause the trade balance to deteriorate.

**Reconciliation of reported and underlying profit before tax****Year ended 31 December 2007 compared with year ended 31 December 2006**

	2006 as reported US\$m	Currency translation <sup>1</sup> US\$m	2006 at 2007 exchange rates US\$m	Acquisitions, disposals and dilution gains <sup>2</sup> US\$m	Underlying change US\$m	2007 as reported US\$m	Reported change %	Underlying change %
Europe								
Net interest income	8,289	635	8,924	416	(1,594)	7,746	(7)	(18)

Net fee income	7,108	586	7,694	(80)	817	8,431	19	11
Other income <sup>3</sup>	7,675	576	8,251	(143)	3,282	11,390	48	40
<b>Net operating income<sup>4</sup></b>	<b>23,072</b>	<b>1,797</b>	<b>24,869</b>	<b>193</b>	<b>2,505</b>	<b>27,567</b>	<b>19</b>	<b>10</b>
Loan impairment charges and other credit risk provisions	(2,155)	(147)	(2,302)	□	(240)	(2,542)	(18)	(10)
<b>Net operating income</b>	<b>20,917</b>	<b>1,650</b>	<b>22,567</b>	<b>193</b>	<b>2,265</b>	<b>25,025</b>	<b>20</b>	<b>10</b>
Operating expenses	(13,871)	(1,076)	(14,947)	(49)	(1,529)	(16,525)	(19)	(10)
<b>Operating profit</b>	<b>7,046</b>	<b>574</b>	<b>7,620</b>	<b>144</b>	<b>736</b>	<b>8,500</b>	<b>21</b>	<b>10</b>
Income from associates	(72)	(6)	(78)	(50)	223	95	232	280
<b>Profit before tax</b>	<b>6,974</b>	<b>568</b>	<b>7,542</b>	<b>94</b>	<b>959</b>	<b>8,595</b>	<b>23</b>	<b>13</b>

For footnotes, see page 130.

### Review of business performance

European operations reported a pre-tax profit of US\$8.6 billion, compared with US\$7.0 billion in 2006, an increase of 23 per cent. On an underlying basis, pre-tax profits improved by 13 per cent.

In March 2007, HSBC acquired its partner's shares in life, property and casualty insurer, HSBC Assurances. The results of HSBC Assurances are excluded from the underlying commentary below.

In Commercial Banking, growth in deposit and lending balances in the UK and ongoing business expansion in Turkey and Malta led to steady growth in revenues. This was partly offset by increased loan impairment charges and higher costs associated with

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business expansion. In Global Banking and Markets, higher income from most businesses was offset by trading losses in Credit and Rates and increased costs. Strong profit growth in Private Banking was driven by an increased client appetite for discretionary portfolios, a rise in lending volumes and further improvements in cross-referrals. In Personal Financial Services, a fall in pre-tax profits reflected ex gratia payments expensed in respect of overdraft fees applied in previous years and a provision for reimbursement of certain charges on historic will trusts and other related services. The "Other" segment benefited from a US\$1.3 billion fair value gain in HSBC's own debt.

The following commentary is on an underlying basis.

**Personal Financial Services** reported a pre-tax profit of US\$1.6 billion, a decrease of 31 per cent compared with 2006. Income growth lagged cost growth, principally as a result of ex gratia payments expensed in respect of overdraft fees applied in previous years which are subject to current legal challenge.

In the UK, HSBC continued to concentrate on enhancing services offered to customers, with the intention of making HSBC the "Best Place to Bank". HSBC Premier was relaunched simultaneously in 35 countries, including the UK. All Personal Internet Banking customers now have the ability to send money in over 80 currencies to 234 countries. To make its fees and charges more transparent, HSBC in the UK began to show warning messages on ATMs if the customer's cash withdrawal would cause a fee to be incurred.

In France, successful marketing campaigns continued to improve brand awareness and grow customer numbers, specifically HSBC Premier and Student accounts. The latter benefited from the signing of 120 partnerships with business schools.

In Turkey, the benefit of significant growth from new customer acquisition, boosted by successful cross-sell activities and higher balances, more than offset increased costs incurred in supporting business expansion.

Net interest income was broadly in line with 2006. In the UK, effective deposit pricing, coupled with interest rate rises in the first half of 2007, led to wider deposit spreads and higher balances. This benefit was partly offset by lower margins on mortgages as customers switched to fixed rate products.

Average unsecured lending balances in the UK declined by 5 per cent as HSBC restricted its credit appetite to customers who satisfied tighter underwriting criteria. Spreads narrowed as the portfolio mix shifted towards these better quality, lower-yielding loans.

Savings balances grew by 15 per cent, driven by competitive rates and new products, such as the Online Bonus Savers, a "one click" savings product offering real-time account opening, instantly ready for funding. Together with improved spreads, this contributed to a 29 per cent increase in net interest income on savings products.

Average current account balances in the UK increased to US\$31 billion. Sales of HSBC's premium service, fee-based current accounts (HSBC Premier and Plus) remained major drivers of underlying performance, with significant year-on-year sales growth.

UK credit card balances grew by 4 per cent in a declining market, with growth concentrated in the Partnership card and Marks and Spencer ("M&S Money") portfolios. This benefit was more than offset by pressure on spreads driven by a run-off in higher-yielding accounts in the Partnership cards business. In line with the Group's risk-based concentration on a narrower range of customers, HSBC disposed of part of its non-core credit card portfolio, principally the Marbles brand, in the last quarter of 2007.

In light of changing market conditions, significant investment was made in retraining the mortgages sales force during 2007. Average mortgage balances were broadly in line with last year, while the portfolio mix shifted towards fixed rate products. This, together with base rate rises, caused spreads to tighten.

In France, customer acquisition and the consolidation of existing relationships resulted in an 8 per cent rise in average deposit balances, higher than the overall market increase. Average lending balances grew by 16 per cent, mainly property-related lending. The benefit of these increases in volumes was more than offset by narrower spreads due to competitive pressures and maturing of previously higher-yielding hedging products. As a result, net interest income fell by 11 per cent.

In Turkey, net interest income increased by 17 per cent due to strong balance sheet growth. HSBC added over 600,000 new personal customers during 2007, significantly exceeding its target. Average deposit balances rose by 28 per cent, largely driven by customer recruitment through new branch openings and ongoing efforts to build brand awareness. Deposit spreads remained narrow as



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interest rates started to decline during the second half of 2007 following rate rises earlier in the year. Average lending balances increased by 28 per cent. The income benefit from these increases was partly offset by the impact of market-wide credit calming measures which, together with increased competition, adversely affected margins on lending and credit cards.

Net fee income increased by 13 per cent, largely driven by higher sales of fee-earning packaged current accounts in the UK and credit cards in Turkey, where HSBC recorded significant growth of over 740,000 new cards. This was partly offset by a US\$25 million decrease in credit card default fees in the UK as HSBC reduced its fee following the outcome of an investigation by the OFT in April 2006. In France, fee income grew by 7 per cent through improved transactional commissions, mainly from increased sales of packaged accounts and higher life insurance fees.

In the UK, pensions and life investment sales increased as did home and motor insurance sales, the success of the M&S Money motor insurance campaign led to M&S Money rising to fourth in the market for online sales. However, the insurance results were adversely affected by lower income from payment protection products and flood claims in the summer.

Net trading income largely reflected the fair value measurement of embedded options linked to government regulated home savings products in France. In 2006, there was a large gain; this did not recur in 2007.

Gains on the sale of financial investments in 2007 included a share in HSBC's sale of Marfin Popular Bank, an investment acquired in a share swap agreement with The Cyprus Popular Bank as part of the sale of HSBC's stake in the latter in 2006. In addition, a gain arose from the merger of two payment services providers and there were two further gains on the share of profits from the MasterCard Incorporated IPO, although to a lesser extent than in 2006.

Other operating income declined significantly, due to a fall in the present value of in-force (PVIF) long-term insurance business, following a change in FSA regulations which permitted certain rules relating to the calculation of actuarial liabilities for the long-term insurance business to be relaxed. This was offset by a corresponding reduction in provisions reported in Net insurance claims and movements in liabilities to policyholders. HSBC recorded a loss on the disposal of the Marbles brand cards portfolio, offset by the sale of other card

portfolios at a profit. In 2006, HSBC benefited from a share of the gain on the sale of its stake in The Cyprus Popular Bank.

Loan impairment charges and other credit risk provisions of US\$2.0 billion were 4 per cent higher than in 2006. In the UK consumer finance business, refinements to the methodology used to calculate roll-rate percentages resulted in a higher charge in the first half of the year. Excluding this, loan impairment charges were marginally lower than in 2006. Loan impairment charges in the second half of 2007 were lower than in the first half of the year, as overall credit quality improved following measures taken in the recent past to tighten underwriting standards and improve the credit quality of new business. Although losses from mortgage lending remained low, maximum loan to value ratios were reduced during the year to mitigate the effects of a possible housing market downturn. In France, loan impairment charges remained low, albeit higher than in 2006, as credit quality remained good. In Turkey, credit quality remained stable and growth in loan impairment charges followed increases in lending balances.

Operating expenses were 11 per cent higher than in 2006. In the UK, US\$227 million arose from ex gratia payments expensed in respect of overdraft fees applied in previous years, and a further US\$169 million was provided for reimbursement of certain charges on historic will trusts and other related services.

HSBC concentrated discretionary investment on technology that promotes straight-through processing, allowing customers to purchase products online. This will improve processing time and reduce errors caused by human intervention. As part of the ongoing branch refurbishment programme, a further 52 branches were refurbished during 2007.

In France, operating expenses rose as HSBC made further investments to take advantage of Group synergies. In October 2007, IT systems were successfully migrated onto HSBC's core banking platform. This will enable HSBC France to integrate its branded operations and benefit from the Group's expertise in technology, process and products. In Turkey, ongoing investment in capacity and infrastructure to support business growth, as evidenced by the opening of 45 branches during 2007, contributed to a 17 per cent increase in operating expenses.

**Commercial Banking** reported a pre-tax profit of US\$2.5 billion, an increase of 4 per cent. Revenues rose by 12 per cent as a result of both balance sheet growth and an increase in fee-based

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product income, driven by customer recruitment and the expansion of the small and mid-market segments in Turkey and Malta. These benefits were partly offset by higher loan impairment charges, principally on corporate relationship managed accounts in the UK and increased operating expenses from ongoing business expansion throughout the region.

HSBC continued to expand the scope of its services in European emerging markets with the recruitment of a further 36 relationship managers. HSBCnet was launched in Armenia, Kazakhstan, Malta, Poland, the Czech Republic and Slovakia during the year. Significant income growth was recorded in Armenia and Poland, countries which offer potential for high GDP growth going forward and demand for conventional trade services.

In support of HSBC's strategy to be the leading international commercial bank, dedicated international corporate teams were established in London and Paris to drive and support cross-border business. Global Links and International Business Centres are now available in 11 European countries, simplifying cross-border account opening for customers and more than tripling successful outward referrals over 2006.

Net interest income increased by 7 per cent in 2007, largely from growth in the UK, Turkey, Germany and Malta. In the UK, a 10 per cent growth in deposit balances was primarily driven by a successful negotiated-rate deposit product launched in 2005. This helped fund lending growth of 14 per cent, which was largely the result of strong growth in corporate and structured banking and customer numbers in commercial centres. These income benefits were partly offset by narrower margins on loans and overdrafts as a result of increasingly competitive market conditions.

In France, HSBC continued to increase its client base, reflecting the ongoing success of initiatives to raise its brand profile and improve customer segmentation. HSBC reinforced its position as the leading international bank and increased the recruitment of new customers, particularly small businesses with high potential. Average lending balances increased by 19 per cent and average deposit balances, boosted by the financial markets crisis in the second half of the year, increased by 22 per cent. The income benefit of this balance sheet growth was more than offset by competitive pressures on margins and the maturity of previously higher-yielding hedging products. As a result, net interest income was slightly lower than 2006.

Net interest income in Turkey increased by 46 per cent, as HSBC continued to develop its

service offerings for its micro, small and mid-market business customers. Income benefited from growth of 108 per cent in small and micro customer lending together with a 114 basis point increase in spreads. This upward trend in lending spreads was driven by new product bundles and growth in Commercial Banking's profitable overdraft account. Average deposit balances rose by 4 per cent in Turkey, in part due to an increase in cash management clients, with wider margins further benefiting income.

Net fee income increased by 18 per cent. Excluding Commercial Banking's share of Insurance Brokers' fees previously reported in the "Other" segment, net fee income rose by 5 per cent. In the UK, a modest increase in net fee income was driven by growth in foreign exchange fees and card activity following the small-business credit card product successfully launched in May 2006. In Turkey, net fee income grew by 42 per cent, driven by investment banking, advisory and structured finance transactions, mainly due to a 15 per cent increase in corporate clients. Trade products also drove fee income and referrals from other HSBC Group offices which further contributed to the increase. In France, net fee income grew by 9 per cent, as customer acquisition and the consolidation of existing relationships led to a 9 per cent increase in transaction fees.

Gains on the sale of financial investments in 2007 reflected Commercial Banking's share of HSBC's sale of Marfin Popular Bank, an investment acquired in a share swap agreement with The Cyprus Popular Bank Limited ("Cyprus Popular Bank"), as part of the sale of HSBC's stake in the latter in 2006. 2007 benefited from further gains on the share of profits from the MasterCard Incorporated IPO, to a similar extent as in 2006.

Other operating income declined significantly, due to a fall in the PVIF long-term insurance business, following a change in FSA regulations. This was offset by a corresponding reduction in provisions reported in "Net

insurance claims and movements in liabilities to policyholders]. The non-recurrence of Commercial Banking's US\$38 million share of the gain on the sale of HSBC's stake in Cyprus Popular Bank also contributed to the fall in other operating income.

Loan impairment charges and other credit risk provisions remained low despite a 23 per cent rise on levels recorded in 2006. In the UK, loan impairment charges increased; this was concentrated in four large corporate accounts. In France, credit quality remained good and loan impairment charges stayed

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low despite balance sheet growth. In Turkey, increased charges reflected growth in lending volumes as general credit quality remained satisfactory.

Excluding Insurance Brokers, operating expenses increased by 7 per cent. Across Europe, costs were higher as a result of sales staff recruitment and other costs to support business development and expansion, particularly in Turkey and Eastern Europe. In addition, France incurred incremental restructuring costs relating to the migration of IT systems onto HSBC's core banking platform.

**Global Banking and Markets** in Europe reported a pre-tax profit of US\$2.5 billion, broadly in line with 2006 despite write-downs in credit, structured credit derivatives and certain positions in leveraged and acquisition finance, resulting from the challenging credit market in the second half of 2007. Apart from these product lines, the Global Markets and Global Banking businesses reported robust growth complemented by significant gains on principal investments. The cost efficiency ratio deteriorated by 3 percentage points.

Total operating income increased by 7 per cent to US\$7.6 billion. Strong foreign exchange and equities trading income drove revenue growth, enhanced by higher advisory fees and fair value gains in financing and capital markets. Securities services benefited from higher transaction volumes driven by increased market volatility. A rise in revenues from payments and cash management and principal investments further boosted income. This growth was partly offset by significant write-downs in credit and structured derivatives.

In the UK, payments and cash management income grew due to higher customer balances, which rose as the liquidity crisis led customers to increase their cash balances. In Turkey, higher balance sheet management revenues contributed US\$12 million.

Net fee income was 28 per cent higher, with robust growth in income from financing businesses in line with greater market activity in the UK and France in the first half of 2007. In securities services, a rise in volumes and new client mandates drove the increase in revenues. Assets under custody grew by 16 per cent.

Overall, income from trading activities fell due to US\$713 million of write-downs reported in credit, structured credit derivatives and leveraged and acquisition finance in the UK. These were partly offset by strong growth in foreign exchange driven by market volatility and a weakening US dollar. In

equities, strong trading income from core products was supplemented by a gain from the sale of Euronext shares. In France, the continuing trend of higher income from structured derivatives reflected the benefit of investment to enhance capabilities. The credit market dislocation also led to an adverse fair value adjustment in respect of loan commitments outstanding when global credit spreads widened in the second half of 2007.

The UK principal investments business benefited a small number of significant realisations during the year. Gains less losses from financial investments rose to US\$1.1 billion.

A net recovery on loan impairment charges, albeit lower than in 2006, reflected the continued low level of corporate credit defaults.

Operating expenses rose by 12 per cent to US\$5.2 billion. Operational costs rose in Global Markets, particularly in structured derivatives where the French businesses invested to support local revenue growth. Costs also rose in payments and cash management and securities services, driven by the rise in business volumes. Additional staff costs resulted from recruitment in selected businesses during 2006.

HSBC's share of profits from associates recovered due to the non-recurrence of an impairment charge on a private equity investment held by an associate in 2006.

**Private Banking** reported a pre-tax profit of US\$915 million, an increase of 11 per cent. A strong performance in Switzerland was driven by the promotion of advisory and discretionary mandates, with existing clients further leveraging their portfolios. Profits in the UK declined as a result of lower gains from the partial disposal of the Hermitage Fund. Excluding this transaction, UK revenue increased strongly. The cost-efficiency ratio increased slightly by 0.9 percentage points to 56.9 per cent, affected by lower investment gains in 2007. Despite this, the cost efficiency ratio is one of the strongest in the industry.

Net interest income rose by 14 per cent to US\$793 million. Switzerland contributed the majority of the increase. Loans and advances to customers increased by 31 per cent to US\$13.8 billion, as existing clients further leveraged their portfolios to take advantage of alternative investment opportunities. Monaco and Germany also contributed to the rise in net interest income. In Germany, net interest income increased by 14 per cent due to a large growth in deposits. Similarly, in Monaco, customer accounts rose, augmented by

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higher lending balances as existing clients increased their leverage.

Net fee income increased by 15 per cent to US\$1.0 billion, mainly due to a 10 per cent increase in funds under management in Switzerland with discretionary and advisory funds generating higher annual fees. Client investments in structured products and brokerage fees also contributed to the rise in fee income. In the UK, fees increased by 10 per cent, driven by a rise in wealth and loan fees.

Trading income was 63 per cent higher at US\$170 million, mainly driven by foreign exchange trading by clients in Switzerland.

Gains from financial investments decreased by 23 per cent to US\$115 million. This primarily related to a gain from a partial disposal of a seed capital investment in the Hermitage Fund which was lower than that recognised from an earlier disposal in 2006.

Client assets, which include deposits and funds under management, grew by 19 per cent to US\$258.4 billion. The large growth in client assets was driven by positive market performance and US\$20.2 billion of net new money, with Switzerland contributing US\$7.1 billion and the UK and Monaco contributing US\$3.7 billion and US\$3.6 billion each. The growth in cross-referrals continued, with inward referrals from other customer groups contributing US\$3.9 billion to total client assets.

Operating expenses were 15 per cent higher than in 2006, driven by business expansion. More front-office staff, higher performance-related bonuses, IT and marketing costs all contributed to the rise. The overall increase in operating expenses was partially offset by the effect of a change in pension arrangements.

Within **Other**, fair value movements in HSBC's own debt and related derivatives resulted in gains of US\$1.3 billion, largely as a consequence of movements in credit spreads. These movements will reverse through the income statement over the life of the debt unless the debt is repaid before its contractual maturity. This segment also benefited from a US\$73 million adjustment to the embedded value of HSBC's associate, HSBC Assurances, prior to the acquisition of its remaining capital, from which date it was accounted for as a subsidiary.

Year ended 31 December 2006 compared with year ended 31 December 2005

### **Economic briefing**

**UK** GDP growth increased in 2006 to 2.9 per cent from 1.8 per cent in 2005. This followed a recovery in both household and company spending. CPI inflation increased through the year from 1.9 per cent in January to 3 per cent in December, following large increases in the price of petrol and gas. The Bank of England raised interest rates from 4.5 per cent to 5 per cent, citing concerns about spare capacity, rapid money growth and the possibility of inflation staying above target for some time. House price inflation remained strong but consumer spending appeared unaffected. Secured lending continued to increase although unsecured lending plateaued. There was evidence that a number of households were struggling with the burden of debt as personal insolvencies and repossessions increased. Employment rose, although by less than the increase in available workers as migrant inflows remained strong and the participation rate of UK residents in the labour force increased. As a result, the unemployment rate increased, contributing to constrained wage growth throughout the year despite relatively high rates of headline inflation.

The recovery in the **eurozone** economy gathered momentum through the course of 2006. GDP rose by approximately 2.7 per cent, the fastest rate since 2000. Much of the improvement reflected increases in exports and investment, as global demand remained strong and corporate activity and profits rose. Consumer spending remained subdued, despite a gradual rise in employment. German growth improved sharply, while growth in France and Italy was less impressive. Eurozone inflation was heavily affected by rises in energy and food prices. Inflation, excluding energy and food, remained contained at just 1.7 per cent. The ECB increased the key policy interest rate from 2.25 per cent at the beginning of 2006 to 3.5 per cent in December. The ECB continued to describe monetary policy as "accommodative", thereby effectively ending the year with a bias towards tightening.

**Turkey's** economy slowed markedly in the third quarter, with year-on-year GDP growth of 3.4 per cent, down from 7.8 per cent in the second quarter. The current account deficit continued to widen, reaching 8 per cent of GDP in December, partly from high-energy prices but also from the increasing substitution of imported materials for local ones due to the overvalued currency. More than half of the deficit was financed by healthy foreign direct investment inflows. The International



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*Europe > 2006***Reconciliation of reported and underlying profit before tax**

Year ended 31 December 2006 compared with year ended 31 December 2005

<b>Europe</b>	2005 as reported US\$m	Currency translation <sup>1</sup> US\$m	2005 at 2006 exchange rates US\$m	Acqui- sitions and disposals <sup>2</sup> US\$m	Underlying change US\$m	2006 as reported US\$m	Reported change %	Underlying change %
Net interest income	8,221	7	8,228	□	61	8,289	1	1
Net fee income	6,299	82	6,381	□	727	7,108	13	11
Other income <sup>3</sup>	6,284	189	6,473	(11)	1,213	7,675	22	19
Net operating income <sup>4</sup>	20,804	278	21,082	(11)	2,001	23,072	11	9
Loan impairment charges and other credit risk provisions	(1,929)	(25)	(1,954)	□	(201)	(2,155)	(12)	(10)
Net operating income	18,875	253	19,128	(11)	1,800	20,917	11	9
Operating expenses	(12,639)	(131)	(12,770)	□	(1,101)	(13,871)	(10)	(9)
Operating profit	6,236	122	6,358	(11)	699	7,046	13	11
Income from associates	120	6	126	(19)	(179)	(72)	(160)	(142)
Profit before tax	6,356	128	6,484	(30)	520	6,974	10	8

For footnotes, see page 130.

Monetary Fund's programme for Turkey remained on track.

### **Review of business performance**

European operations reported a pre-tax profit of US\$7.0 billion compared with US\$6.4 billion in 2005, an increase of 10 per cent. On an underlying basis, pre-tax profits grew by 8 per cent. Underlying net operating income increased by 8 per cent, in line with operating expenses. Commercial Banking delivered a third successive year of growth, driven by strong balance sheet growth in the UK and organic expansion in Turkey. Record profits in Private Banking were driven by strong client asset inflows, a more sophisticated product mix and lending growth. Global Banking and Markets made encouraging gains in trading activities, and operating expenses rose in line with net operating income. In Personal Financial Services, net operating income growth slowed as HSBC tightened its underwriting criteria on unsecured credit. An emphasis on deposit, wealth and insurance products contributed to an increase in costs, which were driven by infrastructure investment both in the physical environment and direct channels.

The following commentary is on an underlying basis.

**Personal Financial Services** reported a pre-tax profit of US\$1.9 billion, 2 per cent lower than in 2005. Net operating income rose by 4 per cent and loan impairment charges increased by slightly more than revenues as increasing numbers of debtors sought formal protection from their obligations.

Costs grew by 7 per cent, reflecting investment in infrastructure throughout the region, and the cost efficiency ratio rose by 1.2 percentage points to 59.2 per cent.

In the UK, HSBC responded to concerns over high levels of consumer indebtedness and the growth in personal bankruptcies and individual voluntary arrangements (IVAs) by adopting more selective underwriting criteria and reducing credit origination. Revenues from credit-related insurance declined as a consequence. In response, HSBC increased its focus on non credit-related income streams, particularly savings and high-value current accounts. Strong balance growth in these products was achieved through marketing initiatives, competitive pricing and the success of innovative propositions such as the packaged Plus and Passport current accounts, the latter supported by the implementation during the year of a more refined approach to customer segmentation.

Considerable strategic attention was given to enhancing product distribution and channel management. The branch refurbishment programme continued and improvements were made to direct banking, notably the introduction of self-service machines and the upgrading of cash machine service offerings. HSBC's internet offering was also enhanced to offer personalised content and sales capabilities, with improved customer accessibility.

In France, a marked improvement in brand awareness after the 2005 rebranding to HSBC France, supported by competitive pricing, aided the recruitment of target customers and consequential

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balance sheet growth, most notably in residential property lending. Despite this growth, there was a decline in profit before tax, due to competitive pressures on margin and the time lag between incurring costs on customer acquisition and earning incremental revenue from future opportunities to cross-sell.

In Turkey profit before tax declined by 2 per cent, as revenue growth was offset by investment costs. Organic development was furthered by the opening of 37 new branches during the year, bringing the total to 193, and a number of marketing initiatives to build brand awareness. Balance sheet and revenue growth accelerated as a result, as did customer recruitment. Overall customer numbers stood at 2.3 million at the end of 2006.

Net interest income increased by 5 per cent to US\$5.7 billion, substantially from balance sheet growth throughout the region.

In the UK, net interest income was driven by growth in savings, deposit and current accounts, with higher balances achieved through targeted sales and marketing efforts. Interest income from credit cards and mortgages also increased.

A focus on liabilities helped boost new UK savings account volumes markedly in a buoyant yet highly competitive savings market. HSBC's competitive internet-based products were the key driver of growth. Cash invested in First Direct's 'e-savings' product trebled; balances in HSBC's 'Online Saver' increased sixfold. Overall, average savings balances, excluding money market investments, increased by 28 per cent and net interest income rose by 25 per cent.

Current account balances in the UK increased by 6 per cent to US\$26.0 billion. Within this, the proportion of value-added packaged current accounts attracting fees rose significantly. The number of HSBC's fee-based accounts more than doubled during 2006. In aggregate, packaged current account balances increased by 25 per cent and represented nearly half of the overall increase in current accounts. Spreads remained broadly in line with 2005.

Average UK credit card balances rose by 5 per cent, to US\$13.7 billion, driven by promotional campaigns and marketing. Growth was strongest in M&S branded cards, which represented 4 percentage points of the increase, driven by an increased sales focus which included extensive media advertising. This was partly offset by declining balances within the store cards business and the cards business of HFC Bank Ltd ('HFC'), reflecting HSBC's more restricted credit appetite. Spreads increased modestly compared with 2005.

Average UK mortgage balances rose by 11 per cent to US\$68.9 billion, primarily in fixed rate mortgages. Growth was achieved through competitive pricing and targeted marketing strategies, including the launch of new fixed, discount and tracker-rate mortgages during the year. A slight narrowing of spreads reflected a change in mix away from variable rate mortgages to fixed rate mortgages, and the competitive positioning referred to above.

Average unsecured lending balances in the UK declined by 4 per cent, reflecting HSBC's decision to contain growth through stricter underwriting criteria. Spreads narrowed, following the introduction in 2005 of preferential pricing for lower-risk customers, and a change in mix towards higher-value but lower-yielding loans.

In France, net interest income fell by 8 per cent. Spreads narrowed as older higher-yielding investments matured, while competitive pricing reduced lending yields, particularly in the residential mortgage market. These pressures on margin were only partially offset by strong balance sheet growth. Marketing campaigns building on the 'HSBC France' brand aided strong sales and customer recruitment, most notably in residential property lending and current accounts and also increased future cross-selling opportunities.

In Turkey, net interest income rose by 14 per cent. Lending grew strongly, substantially funded by deposit growth. Overall, deposit balances rose by over 50 per cent, largely driven by customer recruitment aided by the branch network expansion referred to above. Spreads widened following increases in overnight interest rates and the value of funds rose as a consequence. Marketing initiatives and cross-sales with credit card customers helped more than double average unsecured lending balances. Mortgage lending was also strong, with a 60 per cent increase in balances. Credit card balances rose by 22 per cent, with growth dampened by credit calming

measures imposed by government regulation.

Net fee income increased by 8 per cent to US\$2.5 billion. In the UK, rising sales of fee-earning packaged current accounts, travel money and investment products drove fee growth. Fees from unsecured lending also rose. These benefits were partly offset by lower creditor protection income, reflecting the steps taken by HSBC to constrain lending growth. Reduced loan sales and smaller average loans (the result of this initiative) led to both

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lower insurance sales and a reduction in average premiums.

In France, banking fees rose through higher sales of packaged current accounts. Transactional and overdraft fees and insurance distribution fees also increased, reflecting growth in the customer base. In Turkey, strong growth in lending volumes and, to a lesser extent, credit cards, helped drive fee income growth. Additional sales staff were recruited to reinforce the emphasis on wealth management, and the launch of new pension products also helped boost fees.

In 2006, MasterCard became publicly listed through an IPO, and the US\$37 million gain from financial investments mainly reflected Personal Financial Services' share of the proceeds of the IPO.

Responding to changes in work and shopping patterns among its customers and the increasing acceptance of direct channels. HSBC appraised its UK property portfolio during the year, and higher other operating income reflected Personal Financial Services' share of revenue from branch sale and lease-back transactions. Personal Financial Services' US\$37 million share income on the sale of HSBC's stake in Cyprus Popular Bank was also included within other operating income.

Lower sales of life and creditor repayment protection, which were driven by the constraints on personal lending growth referred to above, and a change in reinsurance arrangements at the end of 2005, contributed to the decrease in net earned insurance premiums. Lower sales of investment-linked insurance products, together with the effect of market movements on related insurance and investment assets, contributed to the decline in net income from financial instruments designated at fair value. This was largely offset by a corresponding decrease in net insurance claims and movements in policyholders' liabilities.

Loan impairment charges and other credit risk provisions of US\$1.8 billion were 6 per cent higher than in 2005, largely reflecting lending growth in the region.

In the UK, the 8 per cent rise in loan impairment charges was broadly in line with lending growth. Actions taken on underwriting and collection activities mitigated a continuation of the rising trend in personal bankruptcies and IVAs seen since the legislative change in 2004. In 2006, IVAs became the main driver of loan impairment growth across the industry as the availability and marketing of third-party debt reduction services increased.

Within the UK, loan impairment was most pronounced in consumer finance unsecured portfolios, in which delinquency also rose as the effect of interest rate increases on relatively high levels of indebtedness put pressure on household cash flows. In HSBC's other portfolios, action undertaken by HSBC during 2005 and early 2006, predominantly tightening underwriting criteria and collections procedures, proved successful in improving credit quality indicators on more recently written debt. In the second half of 2006, HSBC strengthened the measures available to manage insolvencies and impaired debt including, *inter alia*, the further development of predictive modelling to enhance underwriting decisions.

In France, credit quality was sound notwithstanding strong growth in customer advances, and the loan impairment charge remained low. In Turkey, overall credit quality was also sound, and delinquency on credit cards improved following enhanced collections efforts and changes in government regulation. This was reflected in a 36 per cent reduction in loan impairment charges.

Operating expenses increased by 7 per cent. A US\$57 million write-down of intangibles was attributed to card portfolios acquired in the UK which were written off in the light of the higher impairment charges being experienced. Excluding this item, the increase was 6 per cent, primarily reflecting investment in upgrading and expanding capacity and infrastructure across the region.

In the UK, 104 branches were refurbished during 2006. Responding to changing customer preferences and upgrading its customer service, HSBC extended its opening hours in certain branches, necessitating the recruitment of additional counter staff, and increased its IT investment in self-service machines and other direct banking channels, in the process improving cost efficiency.

In France, there was a 4 per cent rise in operating expenses, driven by the recruitment of additional sales staff, higher marketing expenditure to attract new customers, and the migration to a common IT infrastructure. In Turkey, the opening of 37 new branches and associated growth in numbers of sales staff and infrastructure costs drove a 26 per cent rise in costs. Marketing expenditure also increased in support of the growing consumer lending, insurance and pensions businesses.

**Commercial Banking** reported a pre-tax profit of US\$2.2 billion, an increase of 14 per cent compared with 2005. Adjusting for the sale of the UK fleet management and vehicle finance leasing business, which was sold in the autumn of 2005,

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profit before tax grew by 17 per cent, driven by growth of 10 per cent in net operating income compared with just 4 per cent in costs. Revenues increased by 9 per cent through balance sheet growth, customer recruitment and improved cross-sales in the UK, and expansion of the middle market, small and micro-businesses in Turkey. The 4 per cent growth in operating expenses primarily reflected investment to support business expansion throughout the region. Credit quality was stable.

In the UK, HSBC invested to expand sales capacity and improve service through recruitment and the opening of commercial centres. To support HSBC's strategic intention to lead the market in international commercial banking, a dedicated International Banking Centre was created which, as part of a global network, simplified cross-border account opening. HSBC also simplified and launched new foreign currency accounts. Significant progress was made in enhancing the functionality of HSBC's award-winning internet banking, including the implementation of the UK's first same-day high-value payments offering and the launch of HSBC's first commercial direct banking proposition, Business Direct, which attracted over 19,000 small and micro business accounts during the year.

In France, HSBC increased customer recruitment by approximately one third by concentrating on improving brand awareness among commercial businesses. HSBC became the principal banker for the majority of new customers recruited. In Turkey, the establishment of eight centres, the recruitment of additional relationship management staff and a focus on maintaining high service levels contributed to a 40 per cent increase in the number of active customers as HSBC successfully sustained its efforts to grow its share of middle market, small and micro-business banking.

Net interest income increased by 8 per cent, largely driven by increases in the UK and Turkey. In France, the benefit of strong balance sheet growth was more than offset by competitive pressure on margins.

HSBC slowed the rate of growth in lending in the UK during 2006 by refining underwriting criteria and emphasising non-lending related revenue streams and, consequently, average lending balances rose by 8 per cent during the year and spreads remained broadly flat. Increased priority was given to raising deposits through transactional and savings accounts and, as a result, deposit balances rose by 37 per cent and current account balances by 8 per cent. The benefit of this volume growth was partly offset by spread compression on sterling-

denominated accounts as customers were offered more attractive pricing.

HSBC boosted the recruitment of small and micro business customers in the UK by holding commercial theme weeks and increasing client contact by embedding business specialists in selected branches. These initiatives delivered increases in the number of start-up accounts and the number of customers who switched their business from other banks to HSBC. Higher-value international and foreign currency accounts rose as a consequence.

Net interest income in France was broadly in line with 2005 as the benefit of strong balance sheet growth, driven by the acquisition of new customers and improved levels of customer retention, was offset by narrowing spreads from competitive market pressures and lower earnings from free funds.

Net interest income in Turkey increased by 41 per cent, driven by a doubling in lending balances. HSBC extended its geographic coverage through expansion of the branch network, including the launch of eight new centres dedicated to smaller commercial customers, and these boosted customer recruitment. The introduction of pre-approved credit limits for existing customers also contributed to lending growth, and the focus on attracting liability products helped more than double deposit balances.

Net fee income increased by 4 per cent to US\$1.7 billion. Current account and money transmission fees rose as a result of customer recruitment and higher transaction volumes in most countries. In the UK, client workshops and other promotional activities were deployed to support increased sales of treasury products, boosting treasury revenue as foreign exchange volumes grew. In France a 2 per cent increase in income was largely in transactional current account fees, reflecting growth in the customer base.

Other operating income was 41 per cent lower than in 2005 and reflected lower asset finance revenues following the sale of the UK fleet management business referred to above. This was partly offset by the inclusion of Commercial Banking's share of the gain on the sale of HSBC's stake in Cyprus Popular Bank (US\$38 million),

and the income from UK branch sale and lease-back transactions.

Credit quality in Commercial Banking was stable in most countries. In the UK, loan impairment charges and other credit risk provisions fell by 16 per cent, largely due to the non-recurrence of an individual loan impairment allowance against a single customer in 2005. Excluding this, there was a



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Europe > 2006

modest decline in UK impairment charges, as the effect of lending growth was more than offset by improved credit quality, particularly in relation to HSBC's larger exposures. In France, loan impairment charges, while remaining low, returned to a more normal level after relatively high recoveries in 2005. In Turkey, higher loan impairment charges reflected growth in lending.

Operating expenses decreased by 1 per cent. Excluding the sale of the UK fleet management activities referred to above, costs were 4 per cent higher than in 2005, reflecting investment to drive business growth throughout the region. As a result of revenues growing significantly faster than costs, there was a 3.1 percentage point improvement in the cost efficiency ratio. In the UK, increased costs reflected the recruitment of additional sales staff and higher IT expenditure. Costs in France fell by 2 per cent compared with 2005 as savings from cost control offset increases from the recruitment of additional sales staff and expenses associated with the migration to common IT platforms. In Turkey, recruitment and marketing costs incurred in support of the growing small and micro businesses drove a 38 per cent rise in expenses.

**Global Banking and Markets** reported a pre-tax profit of US\$2.3 billion, an increase of 5 per cent, compared with 2005. A reduction in recoveries of loan impairment charges and lower private equity gains masked strong growth in core operating activities. Global Markets' revenues were 36 per cent higher than in 2005 as robust performances in the global capital markets and securities services businesses were complemented by strong trading gains. The cost efficiency ratio improved modestly compared with 2005.

Total operating income was US\$6.6 billion, 17 per cent higher than in 2005. This was despite the fact that in the UK, France and Turkey, balance sheet management revenues continued to fall, resulting in an overall decline of 56 per cent. This shortfall was partly offset by higher net interest income in securities services as customer volumes grew in higher-value products such as securities lending and foreign exchange. The lending business delivered a 13 per cent increase in corporate balances and corporate spreads remained broadly in line with 2005.

Net interest income in the payments and cash management business rose as deposit balances increased by 18 per cent. Surplus liquidity in the market fed higher business volumes. Increased transaction volumes resulting from new client

acquisitions and recent expansion initiatives also contributed to higher revenues.

Net fee income rose by 23 per cent, reflecting a 63 per cent fee increase in the global capital markets business and fees more than doubling in the securities services business. The financing and advisory businesses benefited from a higher number of deals mandated and a broader product range. Assets under custody grew by 22 per cent with notable increases in alternative fund assets, particularly from Ireland and Luxembourg.

In HSBC Global Asset Management, revenues increased significantly, boosted by a 4 per cent increase in funds under management and higher performance fees allied to revenues from disposals of property and structured finance fund investments.

Trading income increased with positive revenue trends in the key product areas where HSBC has invested, notably Credit and Rates, foreign exchange and structured derivatives. Revenues increased substantially, particularly in the area of interest rate derivatives, which benefited from opportunities created by a relatively volatile market. Additional gains were reported in emerging market bonds due to higher volumes, as investors adjusted their risk appetite and responded to a general improvement in market sentiment towards developing economies. Higher foreign exchange revenue was driven by greater customer volumes and increased trading

opportunities offered by a combination of US dollar volatility and more uncertain economic conditions in emerging markets. Structured derivatives income increased by 88 per cent as HSBC leveraged its investment in this business to meet the needs of its institutional clients.

Gains from sales of financial investments, at US\$413 million, were in line with 2005. Notable among the investments realised in the year were the sales of specialist property and structured finance fund investments by HSBC Global Asset Management.

Other income declined by 26 per cent as one-off gains from restructuring and syndication of assets in Global Investment Banking were not repeated.

The overall credit environment remained favourable with market liquidity supporting debt reconstruction as credit spreads tightened. As a result, HSBC achieved net recoveries for the third year in succession, albeit at a lower level than in 2005, when HSBC benefited from a release of collective impairment allowances in the second half.

Operating expenses were 14 per cent higher at US\$4.2 billion, largely supporting volume growth

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in various businesses and performance-related compensation in Global Markets, where revenues increased by 36 per cent. Costs in 2006 also reflected the full-year effect of the investment made throughout 2005 as well as ongoing investment in product development, particularly in structured derivatives and Credit and Rates. In HSBC Global Asset Management, a robust performance resulted in higher staff and support costs.

A rise in operational expenditure was driven by increased volumes as well as new business won in respect of payments and cash management funds administration, securities services and Group Investment Businesses.

The decline in HSBC's share of profits in associates and joint ventures reflected a loss arising from an impairment charge on a private equity investment within an associate. This was compounded by the non-recurrence of one-off gains realised in 2005, a significant proportion of which were recognised in the second half of the year.

**Private Banking** delivered a record pre-tax profit of US\$805 million in Europe, an increase of 48 per cent compared with 2005. The cost efficiency ratio improved by 6.7 percentage points to 55.7 per cent. There was a US\$108 million gain on the partial sale of an investment in the Hermitage Fund and, excluding this, pre-tax profit increased by 28 per cent. This result was achieved through growth in client assets, increased lending and transaction volumes and distribution of a broader and more sophisticated product range. Growth in intra-Group referrals with other customer groups was encouraging and also contributed to increased revenues.

Net interest income was 23 per cent higher at US\$675 million, driven by balance sheet growth, primarily in the UK and Switzerland. Lending balances were 24 per cent higher and were funded by increased deposits. In the UK, the 31 per cent expansion of the lending book resulted primarily from growth in mortgage balances driven by a market which remained buoyant at the upper end. In Switzerland, an 18 per cent rise in lending largely reflected client appetite for leverage to facilitate equity and alternative investment opportunities.

Fee income increased by 19 per cent to US\$869 million. This growth resulted from increased funds under management and a favourable mix change towards higher fee-generating discretionary and advisory managed funds, including the continued success of the Structured Investment Solutions (SIS) and Core Investment Solutions (CIS) products and the launch of the Actively

Managed Portfolio product. A significant performance fee came from the Hermitage Fund, a public equity fund dedicated to Russia, which was US\$23 million greater than in 2005. The expansion of HSBC's residential property advisory business, which opened new offices in the UK and France, also contributed to fee income growth.

Gains from financial investments in both 2005 and 2006 arose mainly from the sale of debt and investment holdings. Gains in 2006 included US\$108 million from the partial disposal of HSBC's investment in the Hermitage Fund.

Excluding gains from financial investments, trading and other operating income was marginally lower than in 2005.

Client assets, including deposits, rose by 18 per cent to US\$218 billion. Net new money was US\$19 billion, with the largest inflows arising in Switzerland and the UK. In Switzerland, improved brand awareness, successful product placement and cross-referrals with other customer groups, all contributed to significant net new money of US\$11 billion. In the UK, net new money of US\$3 billion was garnered from referrals from Commercial Banking and the retail network, new regional offices and continued growth in the underlying business. Net new money in Monaco and Germany exceeded US\$1 billion and US\$2 billion, respectively, also contributing to the growth in client assets. The value of clients' investments in HSBC's discretionary managed suite of SIS and CIS products grew very strongly, reaching US\$1.7 billion.

Operating expenses were 13 per cent higher than in 2005 due to higher performance-related remuneration, recruitment of client-facing professionals across the region to support the growth of the business, and continued investment in the recently opened UK regional offices. The combination of HSBC's principal trust businesses in Switzerland also added to costs in 2006 but is expected to bring efficiency gains in subsequent years. Overall

increased expenses were more than offset by greater revenue generation which contributed to the 6.7 per cent improvement in the cost efficiency ratio.

In **Other**, increases in US interest rates led to higher earnings on capital, which were partly offset by increased subordinated debt-servicing costs.

Movements in the fair value of own debt and associated hedges were US\$33 million, compared with an adverse movement of US\$15 million in 2005, principally from movements in HSBC's own credit spread. The fair value of own debt

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*Europe > Profit/(loss) before tax by customer group*

incorporates an element attributable to the credit spread on HSBC's debt instruments. As HSBC's credit spreads narrow, accounting losses are reported, and the reverse is true in the event of spreads widening. These valuation adjustments do

not alter the cash flows envisaged as part of the documented interest rate management strategy.

Operating expenses decreased by 5 per cent, driven by the non-recurrence of litigation expenses in France.

Profit/(loss) before tax and balance sheet data by customer group and global business

**Year ended 31 December 2007**

<b>Europe</b>	<b>Personal</b>		<b>Global Banking &amp; Markets</b>	<b>Private Banking</b>	<b>Other</b>	<b>Inter- segment elimination<sup>14</sup></b>	<b>Total</b>
	<b>Financial Services</b>	<b>Commercial Banking</b>					
	<b>US\$m</b>	<b>US\$m</b>	<b>US\$m</b>	<b>US\$m</b>	<b>US\$m</b>	<b>US\$m</b>	<b>US\$m</b>
Net interest income	<b>6,604</b>	<b>3,419</b>	<b>1,361</b>	<b>793</b>	<b>86</b>	<b>(4,517)</b>	<b>7,746</b>
Net fee income/(expense)	<b>3,060</b>	<b>2,194</b>	<b>2,316</b>	<b>1,032</b>	<b>(171)</b>	<b>□</b>	<b>8,431</b>
Trading income/(expense) excluding net interest income	<b>60</b>	<b>36</b>	<b>2,657</b>	<b>161</b>	<b>89</b>	<b>□</b>	<b>3,003</b>
Net interest income/(expense) on trading activities	<b>(7)</b>	<b>30</b>	<b>(610)</b>	<b>9</b>	<b>1</b>	<b>4,517</b>	<b>3,940</b>
Net trading income/(expense) <sup>5</sup>	<b>53</b>	<b>66</b>	<b>2,047</b>	<b>170</b>	<b>90</b>	<b>4,517</b>	<b>6,943</b>
Net income from financial instruments designated at fair value	<b>126</b>	<b>31</b>	<b>(185)</b>	<b>□</b>	<b>1,254</b>	<b>□</b>	<b>1,226</b>
Gains less losses from financial investments	<b>50</b>	<b>36</b>	<b>1,100</b>	<b>115</b>	<b>25</b>	<b>□</b>	<b>1,326</b>
Dividend income	<b>1</b>	<b>4</b>	<b>155</b>	<b>7</b>	<b>4</b>	<b>□</b>	<b>171</b>
Net earned insurance premiums .	<b>3,511</b>	<b>521</b>	<b>□</b>	<b>□</b>	<b>(22)</b>	<b>□</b>	<b>4,010</b>

Other operating income/ (expense)	<u>54</u>	<u>(35)</u>	<u>853</u>	<u>8</u>	<u>301</u>	<u>12</u>	<u>1,193</u>
<b>Total operating income</b>	<b>13,459</b>	<b>6,236</b>	<b>7,647</b>	<b>2,125</b>	<b>1,567</b>	<b>12</b>	<b>31,046</b>
Net insurance claims <sup>6</sup>	<u>(3,214)</u>	<u>(265)</u>	<u>□</u>	<u>□</u>	<u>□</u>	<u>□</u>	<u>(3,479)</u>
<b>Net operating income<sup>4</sup></b>	<b>10,245</b>	<b>5,971</b>	<b>7,647</b>	<b>2,125</b>	<b>1,567</b>	<b>12</b>	<b>27,567</b>
Loan impairment (charges)/ recoveries and other credit risk provisions	<u>(2,044)</u>	<u>(515)</u>	<u>26</u>	<u>(4)</u>	<u>(5)</u>	<u>□</u>	<u>(2,542)</u>
<b>Net operating income</b>	<b>8,201</b>	<b>5,456</b>	<b>7,673</b>	<b>2,121</b>	<b>1,562</b>	<b>12</b>	<b>25,025</b>
Total operating expenses	<u>(6,635)</u>	<u>(2,941)</u>	<u>(5,150)</u>	<u>(1,208)</u>	<u>(579)</u>	<u>(12)</u>	<u>(16,525)</u>
<b>Operating profit</b>	<b>1,566</b>	<b>2,515</b>	<b>2,523</b>	<b>913</b>	<b>983</b>	<b>□</b>	<b>8,500</b>
Share of profit in associates and joint ventures	<u>15</u>	<u>1</u>	<u>4</u>	<u>2</u>	<u>73</u>	<u>□</u>	<u>95</u>
<b>Profit before tax</b>	<b>1,581</b>	<b>2,516</b>	<b>2,527</b>	<b>915</b>	<b>1,056</b>	<b>□</b>	<b>8,595</b>
	%	%	%	%	%		%
Share of HSBC's profit before tax	<b>6.5</b>	<b>10.4</b>	<b>10.4</b>	<b>3.8</b>	<b>4.4</b>		<b>35.5</b>
Cost efficiency ratio	<b>64.8</b>	<b>49.3</b>	<b>67.3</b>	<b>56.8</b>	<b>36.9</b>		<b>59.9</b>
	<b>US\$m</b>	<b>US\$m</b>	<b>US\$m</b>	<b>US\$m</b>	<b>US\$m</b>		<b>US\$m</b>

**Balance sheet data<sup>7</sup>**

Loans and advances to customers (net)	<b>151,687</b>	<b>106,846</b>	<b>163,066</b>	<b>30,195</b>	<b>481</b>	<b>452,275</b>
Total assets	<b>200,432</b>	<b>124,464</b>	<b>794,673</b>	<b>60,010</b>	<b>4,736</b>	<b>1,184,315</b>
Customer accounts	<b>178,757</b>	<b>99,704</b>	<b>163,713</b>	<b>62,055</b>	<b>725</b>	<b>504,954</b>
The following assets and liabilities were significant to Global Banking and Markets:						
□ loans and advances to banks (net)			<b>89,651</b>			
□ trading assets, financial instruments designated at fair value, and financial investments			<b>395,617</b>			
□ deposits by banks			<b>85,315</b>			

For footnotes, see page 130.

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Year ended 31 December 2006

	Personal Financial Services US\$m	Commercial Banking US\$m	Global Banking & Markets US\$m	Private Banking US\$m	Other US\$m	Inter- segment elimination <sup>14</sup> US\$m	Total US\$m
<b>Europe</b>							
Net interest income	5,653	2,923	1,222	675	14	(2,198)	8,289
Net fee income	2,533	1,707	1,673	869	326	□	7,108
Trading income/(expense) excluding net interest income	119	27	2,636	99	(39)	□	2,842
Net interest income/(expense) on trading activities	(6)	15	(523)	2	1	2,198	1,687
Net trading income/(expense) <sup>5</sup>	113	42	2,113	101	(38)	2,198	4,529
Net income from financial instruments designated at fair value	80	27	11	□	26	□	144
Gains less losses from financial investments	37	22	413	149	3	□	624
Dividend income	2	3	171	5	2	□	183
Net earned insurance premiums .	979	110	□	□	209	□	1,298
Other operating income	128	103	957	13	256	(29)	1,428
<b>Total operating income</b>	<b>9,525</b>	<b>4,937</b>	<b>6,560</b>	<b>1,812</b>	<b>798</b>	<b>(29)</b>	<b>23,603</b>
Net insurance claims <sup>6</sup>	(331)	(19)	□	□	(181)	□	(531)
<b>Net operating income<sup>4</sup></b>	<b>9,194</b>	<b>4,918</b>	<b>6,560</b>	<b>1,812</b>	<b>617</b>	<b>(29)</b>	<b>23,072</b>
Loan impairment (charges)/ recoveries and other credit risk provisions	(1,838)	(386)	64	2	3	□	(2,155)
<b>Net operating income</b>	<b>7,356</b>	<b>4,532</b>	<b>6,624</b>	<b>1,814</b>	<b>620</b>	<b>(29)</b>	<b>20,917</b>
Total operating expenses	(5,447)	(2,298)	(4,224)	(1,010)	(921)	29	(13,871)
<b>Operating profit/(loss)</b>	<b>1,909</b>	<b>2,234</b>	<b>2,400</b>	<b>804</b>	<b>(301)</b>	<b>□</b>	<b>7,046</b>
Share of profit/(loss) in associates and joint ventures	□	□	(96)	1	23	□	(72)
<b>Profit/(loss) before tax</b>	<b>1,909</b>	<b>2,234</b>	<b>2,304</b>	<b>805</b>	<b>(278)</b>	<b>□</b>	<b>6,974</b>

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	%	%	%	%	%	%
Share of HSBC's profit before tax	8.6	10.1	10.4	3.6	(1.2)	31.5
Cost efficiency ratio	59.2	46.7	64.4	55.7	149.3	60.1

	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m
Balance sheet data <sup>7</sup>						
Loans and advances to customers (net)	147,507	81,430	140,277	23,283	2	392,499
Total assets	174,865	98,073	502,340	49,440	3,983	828,701
Customer accounts	152,411	80,312	139,416	47,223	3	419,365

The following assets and liabilities were significant to Global Banking and Markets:

□ loans and advances to banks (net)			63,788			
□ trading assets, financial instruments designated at fair value, and financial investments			219,304			
□ deposits by banks			65,963			

For footnotes, see page 130.



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(continued)

*Europe > Profit/(loss) before tax by customer group/Hong Kong*Profit/(loss) before tax and balance sheet data by customer group and global business (*continued*)

	Year ended 31 December 2005						
	Personal Financial Services US\$m	Commercial Banking US\$m	Global Banking & Markets US\$m	Private Banking US\$m	Other US\$m	Inter- segment elimination <sup>14</sup> US\$m	Total US\$m
<b>Europe</b>							
Net interest income	5,309	2,659	827	548	95	(1,217)	8,221
Net fee income	2,314	1,621	1,339	730	295	□	6,299
Trading income/(expense) excluding net interest income	81	16	1,493	93	(23)	□	1,660
Net interest income/(expense) on trading activities	3	2	159	□	(5)	1,217	1,376
Net trading income/(expense) <sup>5</sup>	84	18	1,652	93	(28)	1,217	3,036
Net income/(expense) from financial instruments designated at fair value	305	71	17	□	(31)	□	362
Gains less losses from financial investments	(4)	4	396	27	16	□	439
Dividend income	2	7	27	9	18	□	63
Net earned insurance premiums .	1,220	115	□	□	264	□	1,599
Other operating income	42	178	1,252	18	329	(216)	1,603
<b>Total operating income</b>	<b>9,272</b>	<b>4,673</b>	<b>5,510</b>	<b>1,425</b>	<b>958</b>	<b>(216)</b>	<b>21,622</b>
Net insurance claims <sup>6</sup>	(577)	(62)	□	□	(179)	□	(818)
<b>Net operating income<sup>4</sup></b>	<b>8,695</b>	<b>4,611</b>	<b>5,510</b>	<b>1,425</b>	<b>779</b>	<b>(216)</b>	<b>20,804</b>
Loan impairment (charges)/ recoveries and other credit risk provisions	(1,711)	(378)	155	5	□	□	(1,929)

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Net operating income	6,984	4,233	5,665	1,430	779	(216)	18,875
Total operating expenses	(5,058)	(2,301)	(3,647)	(891)	(958)	216	(12,639)
Operating profit/(loss)	1,926	1,932	2,018	539	(179)	□	6,236
Share of profit in associates and joint ventures	6	7	96	□	11	□	120
Profit/(loss) before tax	1,932	1,939	2,114	539	(168)	□	6,356

%                      %                      %                      %                      %                      %

Share of HSBC's profit before tax	9.2	9.2	10.1	2.6	(0.8)		30.3
Cost efficiency ratio	58.2	49.9	66.2	62.5	122.9		60.8
	US\$m	US\$m	US\$m	US\$m	US\$m		US\$m

Balance sheet data<sup>7</sup>

Loans and advances to customers (net)	120,302	66,965	107,899	17,368	3		312,537
Total assets	143,095	80,864	367,893	40,971	3,880		636,703
Customer accounts	122,118	61,789	109,086	41,206	1		334,200

The following assets and liabilities were significant to Global Banking and Markets:

□ loans and advances to banks (net)			34,218				
□ trading assets, financial instruments designated at fair value, and financial investments			168,062				
□ deposits by banks			45,075				

For footnotes, see page 130.

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Profit/(loss) before tax by customer groups and global businesses

	Year ended 31 December		
	2007 US\$m	2006 US\$m	2005 US\$m
Personal Financial Services	4,212	2,880	2,628
Commercial Banking	1,619	1,321	955
Global Banking and Markets	1,578	955	922
Private Banking	305	201	190
Other	(375)	(175)	(178)
	<b>7,339</b>	5,182	4,517

Profit before tax

	Year ended 31 December		
	2007 US\$m	2006 US\$m	2005 US\$m
Net interest income	5,483	4,685	4,064
Net fee income	3,362	2,056	1,674
Net trading income	1,242	617	546
Net income/(expense) from financial instruments designated at fair value	676	260	(6)
Gains less losses from financial investments	94	162	108
Dividend income	31	61	41
Net earned insurance premiums	2,797	2,628	2,334
Other operating income	845	834	805
<b>Total operating income</b>	<b>14,530</b>	11,303	9,566
Net insurance claims incurred and movement in liabilities to policyholders .	(3,208)	(2,699)	(2,059)
<b>Net operating income before loan impairment charges and other credit risk provisions</b>	<b>11,322</b>	8,604	7,507
Loan impairment charges and other credit risk provisions	(231)	(172)	(146)
<b>Net operating income</b>	<b>11,091</b>	8,432	7,361
Total operating expenses	(3,780)	(3,269)	(2,867)
<b>Operating profit</b>	<b>7,311</b>	5,163	4,494
Share of profit in associates and joint ventures	28	19	23
<b>Profit before tax</b>	<b>7,339</b>	5,182	4,517
	%	%	%
Share of HSBC's profit before tax	30.3	23.5	21.5
Cost efficiency ratio	33.4	38.0	38.2
Year-end staff numbers (full-time equivalent)	27,655	27,586	25,931

Balance sheet data<sup>7</sup>

	At 31 December		
	2007	2006	2005
	US\$m	US\$m	US\$m
Loans and advances to customers (net)	<b>89,638</b>	84,282	83,208
Loans and advances to banks (net)	<b>63,737</b>	50,359	42,751
Trading assets, financial instruments designated at fair value, and financial investments	<b>102,180</b>	103,734	81,631
Total assets	<b>332,691</b>	272,428	235,376
Deposits by banks	<b>6,420</b>	4,799	4,708
Customer accounts	<b>234,488</b>	196,691	173,726

*For footnote, see page 130.*

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HSBC HOLDINGS PLC

**Report of the Directors: Business Review** (continued)*Hong Kong > 2007*

Year ended 31 December 2007 compared with year ended 31 December 2006

**Economic briefing**

**Hong Kong's** economy remained robust during 2007, with the annual rate of growth of 6.3 per cent. Domestic consumption was the major contributor to economic expansion, supported by the strong labour market. The unemployment rate fell to 3.4 per cent, a nine year low, as the supply of labour remained very tight. Global increases in food and oil prices affected Hong Kong, but the territory also experienced wage inflation, rising import prices and growth in property rental costs. Inflation increased as a result, exceeding 3 per cent in the final quarter of the year.

In response to interest rate cuts in the US and capital inflows into the local market, Hong Kong's main interest rate was cut on three separate occasions during the final months of 2007, with the prime rate ending the year at 6.75 per cent, down by one per cent from its high for the year. Local asset markets benefited accordingly. The previously very strong levels of export growth slowed in the second half of 2007, as demand from the US moderated and the reduction in mainland China's export tax rebate in July temporarily affected Hong Kong's re-exports. Despite relatively modest trade growth, external demand for Hong Kong's services remained strong due to the buoyant tourism sector and increasing cross-border business activities, especially within the financial sector.

**Reconciliation of reported and underlying profit before tax**

Year ended 31 December 2007 compared with year ended 31 December 2006

	2006 as reported	Currency translation <sup>1</sup>	2006 at 2007 exchange rates	Acquisitions, and dilution disposals and gains <sup>2</sup>	Underlying change	2007 as reported	Reported change	Underlying change
<b>Hong Kong</b>	<b>US\$m</b>	<b>US\$m</b>	<b>US\$m</b>	<b>US\$m</b>	<b>US\$m</b>	<b>US\$m</b>	<b>%</b>	<b>%</b>
Net interest income	4,685	(15)	4,670	□	813	5,483	17	17
Net fee income	2,056	(6)	2,050	□	1,312	3,362	64	64
Other income <sup>3</sup>	1,863	(6)	1,857	□	620	2,477	33	33
<b>Net operating income<sup>4</sup></b>	<b>8,604</b>	<b>(27)</b>	<b>8,577</b>	<b>□</b>	<b>2,745</b>	<b>11,322</b>	<b>32</b>	<b>32</b>
Loan impairment charges and	(172)	1	(171)	□	(60)	(231)	(34)	(35)



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growth in loan and deposit balances, generated a rise in net operating income of 37 per cent. The cost efficiency ratio improved to 27.2 per cent. Increased business volumes fed through to higher costs, but these were considerably lower than revenue gains as efficiencies were attained from productivity gains in the sales force and the increased use of automated channels and straight-through processing.

Net interest income grew by 16 per cent to US\$3.3 billion in 2007, due to better margins and growth of average deposit balances. Effective balance sheet management and the successful marketing of key products, including HSBC Premier, further contributed to deposit growth.

Average customer deposits grew by 10 per cent, driven by a series of tactical campaigns and new deposit initiatives, including Deposits SmartPicks, which led to new customer acquisition. The relaunch of Premier, which incorporates seamless international banking connectivity and enhanced service benefits, supported strong growth in the number of customers using the service. At the end of 2007, the number of Premier customers was 15 per cent higher than at the end of 2006, at more than 290,000.

An active property market was underpinned by strong economic conditions and stable domestic interest rates throughout most of the year. The volume of new mortgages grew but spreads tightened in a competitive market. The cross-selling of mortgage-related insurance products, including HomeSure, enhanced overall revenue and customer value. Premier customers were responsible for 45 per cent of new mortgage balances while the launch of a deposit-linked mortgage repayment plan was successful in strengthening customer relationships.

A number of credit card programmes were launched in 2007 which successfully increased overall card balances by 15 per cent, and the total number of cards in circulation rose by 6 per cent to 4.9 million at the end of the year. HSBC's credit card business maintained its leading position in terms of cards in circulation, spending and balances.

HSBC's development of its investment and wealth management platforms benefited from the buoyant stock market in Hong Kong. This led to an increase in fees from the sale of retail securities and retail investment funds, leading to a 103 per cent increase in net fee income to US\$2.0 billion. This was mainly due to higher trading volumes, reflecting rising market turnover and value gains compared with the prior year.

The volume of retail securities transactions registered over 167 per cent growth with 80 per cent of trades performed online. In response to significant increases in market volumes during the year, online trading capacity was augmented to handle a four-fold increase in the peak number of users. In the fourth quarter, credit-related liquidity concerns, fears of a US recession and the implementation of measures in mainland China to dampen the economy led to equity market falls which slowed the rate of growth of fee income from share dealing and investment activities.

Over the course of 2007, investment market sentiment together with continued IPO activity, largely from mainland China, drove total funds under management higher. The introduction of new funds and the launch of awareness campaigns helped to boost income from retail investment funds and structured investment products by 144 per cent. WealthMaster, a new portfolio wealth management sales tool, was introduced during 2007 to support branch staff sales of these products. Equity market performance was a catalyst for significant increases in broking income in Hong Kong.

Credit card fee income rose by 20 per cent, as promotional campaigns led to increased cards in circulation and contributed to a 17 per cent rise in cardholder spending.

Life insurance commission income increased by 50 per cent, boosted by the launch of new products, LifeInvest and LifeSave, a medical cover policy incorporating retirement savings. HSBC extended its market leadership position for share of life insurance new business premiums. Emphasis on lower cost online channels increased the percentage of non-life policies sold through them to 53 per cent, while distribution through telemarketing channels also contributed to increased sales.

Loan impairment charges rose by 47 per cent due to increased card balances. Despite a rise in bankruptcies in Hong Kong, credit quality was stable and non-performing loans as a percentage of advances fell by 10 basis points.

Operating expenses rose by 16 per cent due to higher performance-related pay and a rise in premises costs as demand for space in Hong Kong put upward pressure on rents. Increased marketing expenses reflected business growth and the launch of new initiatives. Higher IT costs were also incurred as new systems were developed. The cost efficiency ratio improved as increased revenues were delivered by sales productivity gains and the use of direct channels.



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HSBC HOLDINGS PLC

## Report of the Directors: Business Review

(continued)

*Hong Kong > 2007*

**Commercial Banking** reported pre-tax profits of US\$1.6 billion, 23 per cent higher than in 2006, due to strong balance sheet growth. The rise in asset balances was supported by active marketing efforts and increased trade volumes in Hong Kong. Higher customer numbers across all segments helped to boost deposits and fee income rose as a result of a wider product range and increased sales of investment products. The cost efficiency ratio improved by 1.2 percentage points. While strong economic growth was a stimulus to revenue growth, HSBC also actively increased its customer base by opening business banking branches and adding frontline staff. Market share increased for key products, including remittances and the integrated account package, Business Vantage, which attracted 36,000 new accounts. Revenues from payments and cash management rose by 17 per cent. A series of reward programmes and customer events strengthened existing client relationships. The launch of SmartForms for cross-border as well as domestic account openings further improved accessibility to services for small businesses. Total customer numbers grew by 9 per cent.

Net interest income rose by 15 per cent as a result of higher deposits, as strong economic growth generated demand for savings products. New customers based in mainland China increased the small and mid-market client base and generated an increase in Hong Kong dollar deposits. Foreign currency deposits, including US dollars, also increased significantly as global interest rates rose and spreads were actively managed in a highly competitive market.

Overall, loans and advances to customers grew by 10 per cent as HSBC continued to increase its lending to manufacturers who were expanding their operations in mainland China, while intra-Asian trade flows continued to accelerate. HSBC also promoted its Green Equipment Financing option to borrowers in Hong Kong to enable them to finance energy-efficient equipment. Successful cross-border referrals rose by 95 per cent, due to continued initiatives promoting regional interaction. Hang Seng Bank also targeted the cross-border activity of small and medium-sized businesses by promoting its import and export products. Market competition squeezed asset spreads on lending to corporate and mid-market business customers.

Increased sales of packaged products to small and micro businesses were partially driven by lending campaigns for equipment financing and micro lending.

The business card launched by HSBC in 2006 was quickly adopted; in 2007, over 21,000 new business credit cards were issued. Spreads, however, tightened due to competitive pressures.

Net fee income of US\$526 million was 16 per cent higher, driven by increased sales of investment products, remittances, and trade services. Demand from commercial clients for retail securities, unit trusts and structured products helped fee income from these products to rise by 173 per cent. Remittance income rose by 26 per cent, boosted by an increase in transaction volumes. In addition, a focus on straight-through processing and simplified account opening procedures attracted customers to fee-based products as the convenience of the internet and other direct options provided them with more flexible options for their business operations.

As a result of several commercial insurance marketing campaigns launched during the year, and a realigned sales force, insurance fee income increased by 11 per cent and net earned insurance premiums rose by 37 per cent. Composite sales teams were established to enable general insurance sales managers to also sell life products.

Improved trading income was underpinned by exchange rate volatility, which drove increased payments and trade activity as well as income from foreign exchange and derivatives. Targeted marketing and the enhancement of Business Internet Banking (BIB) to include forward contracts helped to increase transactions. Trading between US and Hong Kong dollars and the hedging of renminbi transactions also led to higher transaction volumes.

Loan impairment charges fell sharply by 59 per cent due to releases of provisions in a stable credit environment.

Expenses rose by 12 per cent as a result of higher staff costs and rising commercial rents. Staff cost increases reflected a combination of wage inflation, performance-related compensation and the costs of additional client-facing staff to support enhanced product offerings. In addition, marketing costs rose to support branding and campaign activity.

A total of 176,000 customers were registered as internet users at the end of 2007, reflecting wide adoption of direct channel offerings. The BIB site was relaunched in the first quarter of the year, leading to processing cost efficiencies. Call centres were also re-engineered to promote the sale of packaged products. Transactions through direct channels constituted 40 per cent of the total number of transactions.

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**Global Banking and Markets** in Hong Kong reported a pre-tax profit of US\$1.6 billion, which represented a rise of 65 per cent compared with 2006. This was principally due to a recovery in balance sheet management revenues, a strong performance in Global Markets, including significant growth in fees from securities services, and higher income from payments and cash management. The cost efficiency ratio improved by 10.5 percentage points.

Total operating income increased by 43 per cent to US\$2.6 billion, rising significantly as balance sheet management revenues recovered and Global Markets benefited from market volatility, boosting trading income from structured derivatives, foreign exchange and equities.

Along with the improvement in balance sheet management performance, net interest income growth was driven by the continued rise in deposit balances and related margins, reflecting the buoyant local markets.

Net fee income rose by 28 per cent as the strong equities market and healthy investor confidence drove increases in volumes in securities services. Assets under custody rose by 56 per cent due to strong growth in new business.

Trading income increased by 20 per cent, mainly from foreign exchange, structured derivatives, equities and rates. Global Markets benefited from interest rate volatility during the year and a buoyant equity market backed by mainland Chinese stocks listed in Hong Kong, as well as currency volatility as regional currencies rose against the US dollar. Structured products generated strong earnings, particularly due to higher sales of products incorporating equity derivatives. Initiatives taken in previous years to extend the product range, ongoing investments in technical and operating capabilities, and sustained cross-sales efforts stimulated revenue growth.

The corporate credit environment remained benign with a small loan impairment charge, compared with a net release in 2006.

Operating expenses of US\$1.0 billion rose by 13 per cent, 30 percentage points less than revenue growth. The expansion of certain businesses, including equities, structured derivatives and securities services resulted in higher operational expenses. Staff cost growth reflected performance incentives in line with the rise in revenues, and higher staff numbers.

**Private Banking** reported a pre-tax profit of US\$305 million. Excluding a US\$39 million geographical reclassification, the underlying increase was 72 per cent. Client demand for structured products increased, encouraged by the buoyant stock market. The cost efficiency ratio improved by 6.4 percentage points to 43.1 per cent.

Excluding a US\$42 million geographic reclassification, net interest income grew substantially. A significant rise was recorded in both deposits and lending. An increase in relationship managers and HSBC's brand reputation attracted new deposits, and clients continued to leverage their investments due to the relatively low cost of borrowing. This was supported by improved treasury performance, as US dollar and Hong Kong dollar interest rates declined.

Fee income rose by 46 per cent as more clients invested in mutual funds to take advantage of the local stock market performance. In addition, the promotion of discretionary products further contributed to the rise in revenues. The SIS product, which provides clients with externally managed portfolios tailored to their specific needs, proved particularly popular.

Trading income also benefited from the strength of equity markets, with a 59 per cent increase to US\$280 million. Demand for alternative funds and structured equity products was high, particularly for the Forward Accumulator, a product linked to the Hong Kong Stock Exchange.

Client assets grew by 43 per cent to US\$72.7 billion. Net new money contributed to 49 per cent of the increase, driven by a rise in the number of relationship managers and a wide variety of discretionary products. Cross-referrals from other customer groups also increased, with inward referrals from other customer groups contributing US\$898 million of net new money.

Operating expenses were 17 per cent higher at US\$231 million, mainly due to increased employee numbers, predominantly in the front office, higher remuneration and performance-related bonuses awarded in order to retain key staff in a very buoyant market.

Within **Other**, the non-recurrence of gains in 2006 from the sale of properties and investments, notably the sale of UTI Bank Limited and the then Hang Seng head office building, resulted in a higher pre-tax loss in this segment.

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HSBC HOLDINGS PLC

**Report of the Directors: Business Review**

(continued)

*Hong Kong > 2006*

Year ended 31 December 2006 compared with year ended 31 December 2005

**Economic briefing**

**Hong Kong** experienced sustained economic expansion in the second half of 2006 with growth, particularly in exports, regaining momentum following a mild slowdown in the second quarter. Domestic demand underpinned the economy throughout 2006 despite volatility in the stock market, which suffered a correction in the second quarter but recovered strongly in the second half of the year. Falling unemployment, improved household incomes and positive longer-term economic prospects were the key elements supporting domestic consumption. Hong Kong's unemployment rate fell to a six-year low of 4.4 per

cent towards the end of 2006, and the labour market began to tighten in certain sectors, with wage pressure increasingly evident. Despite this, inflation remained low, averaging 2 per cent in 2006. Investment growth surged in the second half of the year as the local interest rate cycle peaked. The residential property market divided, with prices of luxury property exceeding levels last seen in the boom in 1997 while, elsewhere in the sector, activity and prices remained flat. At the same time, investment in the construction sector was weak in the absence of large-scale infrastructure projects and general uncertainty. Externally, trade performance improved in the second half of 2006 following difficulties in the first half of the year due to volatile external demand from western markets.

**Reconciliation of reported and underlying profit before tax**

Year ended 31 December 2006 compared with year ended 31 December 2005

	2005 as reported	Currency translation <sup>1</sup>	2005 at 2006 exchange rates	Acquisitions and disposals <sup>2</sup>	Underlying change	2006 as reported	Reported change	Underlying change
<b>Hong Kong</b>	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m	%	%
Net interest income	4,064	5	4,069	□	616	4,685	15	15
Net fee income	1,674	2	1,676	□	380	2,056	23	23
Other income <sup>3</sup>	1,769	1	1,770	□	93	1,863	5	5
	<u>7,507</u>	<u>8</u>	<u>7,515</u>	<u>□</u>	<u>1,089</u>	<u>8,604</u>	<u>15</u>	<u>14</u>

Net operating income <sup>4</sup>								
Loan impairment charges and other credit risk provisions	(146)	□	(146)	□	(26)	(172)	(18)	(18)
Net operating income	7,361	8	7,369	□	1,063	8,432	15	14
Operating expenses	(2,867)	(3)	(2,870)	□	(399)	(3,269)	(14)	(14)
Operating profit	4,494	5	4,499	□	664	5,163	15	15
Income from associates	23	□	23	□	(4)	19	(17)	(17)
Profit before tax	4,517	5	4,522	□	660	5,182	15	15

For footnotes, see page 130.

### Review of business performance

HSBC's operations in Hong Kong reported a pre-tax profit of US\$5.2 billion compared with US\$4.5 billion in 2005, an increase of 15 per cent. On an underlying basis, pre-tax profit also grew by 15 per cent. Underlying net operating income increased by 14 per cent, driven by widening deposit spreads in Personal Financial Services and Commercial Banking and strong net fee income growth in all customer groups. In Global Banking and Markets, an increase in trading income offset the negative impact of lower balance sheet management income. Underlying operating expenses rose by 14 per cent.

The following commentary is on an underlying basis.

**Personal Financial Services** pre-tax profits increased by 9 per cent to US\$2.9 billion. Net operating income before impairment charges grew by 13 per cent, driven by higher income from savings and current accounts and increased fee income. Marketing activities were successful, helping HSBC enlarge its share of the credit card and mortgage markets and attract higher deposit balances. As a result, customer numbers increased by over 100,000. The cost efficiency ratio improved by 1.1 percentage points as cost growth of 9 per cent was restricted to less than the increase in net revenue. Credit quality remained favourable and

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loan impairment charges were low, although higher than in 2005 when a modest recovery was recorded.

Net interest income of US\$2.9 billion was 10 per cent higher than in 2005, principally as a result of deposit growth and wider liability spreads. Average savings balances increased by 7 per cent to US\$119 billion, reflecting the success of promotional campaigns and HSBC's competitive pricing strategy, and supported by increased demand for deposit products in the rising interest rate environment. Effective deposit pricing amid rising interest rates led to wider deposit spreads.

HSBC increased its share of new mortgage business to 33 per cent, the highest of any lender, benefiting from the launch of a simplified, transparent pricing structure in the first half of 2006 which was supported by extensive media coverage. The relaunch of a number of key products and the introduction of a two-month interest free offer in the fourth quarter of 2006 also contributed to the increase in market share. Excluding the reduction in balances under the Government Home Ownership Scheme, HSBC's mortgage portfolio grew by 7 per cent to US\$23 billion.

Average cardholder balances increased by 16 per cent to US\$3.5 billion and HSBC issued over 1 million new cards during 2006, which led to a 17 per cent rise in cards in issue to a record 4.6 million. The launch of a mass card acquisition programme comprising increased promotional activity, direct marketing and the use of incentives to increase cardholder spending contributed directly to this rise. As a result, HSBC's share of the Hong Kong credit card market increased to 46 per cent of card receivable balances.

Net fee income increased by 32 per cent to US\$977 million. Buoyant regional and global stock markets led to increased demand for equity-based products among local investors and HSBC responded by launching 69 new investment funds, including a number of innovative fund products, designed to meet investors' changing demands in a rising interest rate environment. These launches were supported by greater marketing activity, improved pricing transparency and the development of new customer retention activities. As a result, sales of unit trusts rose by 61 per cent and fee income from the sale of investment products, and custody and broking activities increased by 39 per cent.

The increase in cards in issue led to a 24 per cent rise in credit card fees. Expansion of the current account base, partly due to higher sales of packaged products, led to increased remittance and account

servicing fees. HSBC focused on attracting additional funds from existing Premier customers during 2006 and deposits managed on their behalf increased by 29 per cent, reflecting the success of marketing campaigns and enhanced customer benefits.

Insurance fee income increased by 21 per cent and insurance premiums rose by 13 per cent. The development of HSBC's retirement planning proposition was reflected in the launch of new savings, protection and medical insurance products, supported by increased promotional and marketing activity and the successful development of internet and telephone distribution channels. As a result, sales of life and non-life insurance products rose.

Gains less losses from financial investments increased to US\$14 million, reflecting proceeds from the MasterCard Incorporated IPO. In July 2006, HSBC transferred most of its Asian card acquiring business into a joint venture with Global Payments Inc. HSBC retained a 44 per cent stake in the new venture and recognised an overall gain on transfer of US\$55 million, of which US\$12 million was allocated to the Hong Kong Personal Financial Services business and reported in "Other operating income".

Following a net release in 2005, loan impairment charges of US\$119 million reflected asset growth and lower releases and recoveries. In 2005, rising property prices led to the release of impairment allowances against HSBC's mortgage lending portfolio and against restructured lending facilities, neither of which were repeated in 2006.

Increased staff numbers, additional marketing activity and higher IT expenditure led to a 9 per cent rise in operating expenses. Staff recruited to support extended opening hours, together with higher performance-related remuneration and annual pay rises, led to increased employment costs. These were mitigated by a reduction in

branch back-office staff numbers as customers utilised lower-cost distribution channels for an increasing proportion of their banking business. Rising Hong Kong commercial property rental yields in 2006 coincided with the expansion of certain branches with high growth potential and resulted in higher premises costs. Marketing costs rose in support of promotional activity related to credit cards, insurance and wealth management products. Similarly, IT expenditure rose as improved portfolio management systems and enhanced channel capabilities were delivered in order to drive revenue growth.

In **Commercial Banking**, pre-tax profits increased significantly by 38 per cent to



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HSBC HOLDINGS PLC

## Report of the Directors: Business Review

(continued)

*Hong Kong >2006*

US\$1.3 billion. Net operating income grew by 32 per cent, driven by higher deposit balances and fee income, increased liability spreads and lower loan impairment charges. Cost growth was comfortably within the growth in revenues, and the cost efficiency ratio improved by 1.1 percentage points to 26.1 per cent.

During 2006, HSBC launched a number of initiatives designed to further its position in the small business banking market, including customer service enhancements, improvements to account opening procedures and targeted promotional activity. As a result, Commercial Banking customer numbers increased (by 13,000 to 377,000), as did the number of products sold per customer. Investments to enhance the attractiveness of HSBC's distribution channels improved customer service, facilitated customer acquisition and encouraged the migration of routine transactions to automated channels.

Net interest income rose by 23 per cent to US\$1.3 billion. Deposit and current account balances increased by 10 per cent, partly due to the deployment of a team dedicated to attracting deposits from small businesses, and other service enhancements. BusinessVantage, HSBC's market leading integrated account for business, reinforced its leadership position through increased promotional activity, including a new referral programme. HSBC opened over 25,000 new BusinessVantage accounts in 2006, 21 per cent more than in 2005. Interest rate rises led to a 30 basis point widening of deposit and current account spreads and contributed to increased demand for savings products.

Non-trade lending balances increased by 16 per cent to US\$16.8 billion. The continued strength of the Hong Kong economy and, most importantly, its proximity to the strongly growing mainland Chinese market, led to increased business activity among mid-market clients, resulting in higher demand for credit. Lending to the property and retail sectors was particularly strong, while manufacturers with operations in mainland China raised borrowings to fund further expansion and take advantage of both the growing Chinese domestic market and the strong export climate. HSBC's regional alignment programme, which is designed to identify and capitalise on cross-border financing opportunities between Hong Kong, mainland China, Taiwan and Vietnam was instrumental in contributing to the growth in mid-market lending balances.

Growth in small business lending was facilitated through a streamlined lending process and the adoption of a new credit scorecard. As a result, the number of small business customers borrowing from

HSBC increased by 12 per cent and small business lending balances rose by 9 per cent. Increased competition led to a 12 basis point narrowing of asset spreads.

Net fee income of US\$454 million was 13 per cent higher than in 2005. Cash management and remittance fees increased by 18 per cent, driven by growth in the number of current account customers, enhancements to the product range and increased cross-border remittances. Robust local equity markets prompted the launch of 88 new investment products amid resurgent demand. Sales of unit trusts were consequently 15 per cent higher, while derivative and structured product sales rose by 83 per cent.

The establishment of a new Commercial Banking insurance business in October 2005 contributed to life insurance policy sales more than doubling and an 18 per cent rise in non-life policies in force. As a result, insurance fee income more than doubled and premium income increased by 23 per cent.

Effective promotion contributed to a 31 per cent rise in receivables finance fee income, while increased hedging activity and a rise in the value of multi-currency transactions by Commercial Banking customers contributed to a 57 per cent increase in treasury income.

The transfer of the majority of HSBC's card acquiring business into a joint venture with Global Payments Inc. realised a gain of US\$13 million for Commercial Banking, reported in "Other operating income". Fee income in HSBC's remaining card acquiring business not included in the transfer rose by 43 per cent, reflecting an increase in the number of merchant customers and higher transaction values.

Loan impairment charges decreased by 59 per cent, principally due to the non-recurrence of significant charges against a single client in 2005. Credit quality remained strong and non-performing loans as a proportion of lending balances fell by 22 basis points to 62 basis points, reflecting prudent lending policies and risk mitigation procedures.

Operating expenses increased by 17 per cent to US\$491 million to support the strong revenue opportunities evident in the market. The recruitment of additional sales and support staff and the development of the Commercial Banking insurance business contributed to higher staff numbers which, together with the effect of pay rises, resulted in higher staff costs. Marketing costs rose as HSBC stepped up its advertising and promotional activity, including the launch of the global Commercial

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Banking campaign to build market share. Cost efficiency was improved by the continuing migration of sales and transaction activity to lower-cost direct channels.

**Global Banking and Markets** reported a pre-tax profit of US\$955 million, an increase of 3 per cent compared with 2005. Global Markets performance remained robust, with encouraging revenue growth in areas in which HSBC has invested, complemented by strong income growth in the securities services business. The cost efficiency ratio increased slightly, primarily due to the first full year effect of various growth initiatives taken in 2005.

Total operating income of US\$1.8 billion was 7 per cent higher. Although balance sheet management reported an overall decline, revenues recovered modestly in the second half of 2006 as lower yielding positions matured. In Global Banking, net interest income from payments and cash management activity rose sharply as a 6 per cent increase in deposits was complemented by wider spreads. Revenues benefited from improved customer flows following the launch of services offered through HSBCnet in the latter part of 2005. Income from lending activities decreased as the benefit of higher lending balances was more than offset by the effect of spread compression resulting from an abundance of credit in a highly competitive market.

Net fee income rose by 24 per cent. Securities services reported a 28 per cent increase in fees as buoyant stock markets drove higher customer activity. Debt underwriting volumes increased as tightening credit spreads encouraged issuers to lock in to the favourable credit environment by extending the term of finance or by raising new debt in local markets. By contrast, equity underwriting fees declined.

HSBC Global Asset Management used HSBC's extensive distribution network to take advantage of the global trend of strong investment flows to emerging markets. Higher fees reflected strong performance fees from HSBC's emerging market funds. Client funds under management grew by 23 per cent to US\$35 billion, as HSBC launched new funds to capture increased demand for equity-based investments. Fees from the asset and structured finance business also rose.

Net trading income increased by 18 per cent. HSBC retained its leadership position in foreign exchange, with revenues strengthening as trading activity increased in response to volatility in the value of the US dollar and economic conditions in

certain local markets. Investments in equity sales and trading operations in previous years led to higher revenues. HSBC also benefited from internal synergies linking product structuring and hedging capabilities with distribution scale, as foreign exchange option-linked deposits and other instruments were offered to retail and corporate customers.

Private Equity investments also performed strongly. However, Credit and Rates were adversely affected by lower volumes due to unfavourable market conditions in a rising interest rate environment.

The overall credit environment remained stable with a net recovery of US\$27 million.

Operating expenses increased by 12 per cent to US\$911 million, primarily due to the first full year effect of initiatives implemented in the second half of 2005 which extended the product range in Global Markets and strengthened the regional investment banking platform in Hong Kong.

Additional cost increase reflected a rise in performance-related remuneration coupled with higher operational costs in line with increased volumes, particularly in payments and cash management and securities services businesses.

**Private Banking** contributed a pre-tax profit of US\$201 million, an increase of 5 per cent compared with 2005. Growth in client assets and rising sales of higher fee-generating discretionary managed products were partially offset by the adverse effect of a flattening yield curve on income from the investment of surplus liquidity. Demand for experienced private banking staff in Hong Kong was fierce as competitors built up their locally-based operations and, despite strong revenue growth, the resultant increase in staff costs led to a 5.2 percentage points

deterioration in the cost efficiency ratio to 49.5 per cent.

Net interest income was US\$76 million, in line with 2005. Steady growth in deposit balances was offset by competitive pressure on deposit rates and by a challenging interest rate environment for treasury management activities. Loans and advances to customers at 31 December 2006 were marginally lower than at the same point in 2005 as higher interest rates reduced clients' appetite for credit.

There was excellent growth in fee income, which increased to US\$123 million, a rise of 31 per cent. Growth in funds under management and success in increasing the proportion of clients' assets invested in higher fee-earning discretionary managed assets contributed towards increased fee revenue.

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HSBC HOLDINGS PLC

## Report of the Directors: Business Review

(continued)

*Hong Kong >2006 / Profit/(loss) before tax by customer group*

Fee income growth also benefited from increased client holdings of funds and alternative investments. Trading and other revenues were 18 per cent higher at US\$199 million, driven largely by sales of bonds and structured products.

Client assets increased by 27 per cent to US\$51 billion, with net new money inflows of US\$8 billion. This growth was assisted by better marketing and successful product placement, including a broadening of the discretionary managed product range. Sales of HSBC's discretionary managed SIS and CIS products, in which the value of investments by clients reached US\$1.4 billion, continued to be a key driver of this asset class. Continued investment in relationship management, improved stock market performance and growing cross-referrals from within the Group, primarily the retail and commercial networks, also added to the growth.

Operating expenses were 31 per cent higher than in 2005, primarily due to increased staff costs driven by recruitment and the retention of front office staff in a competitive market, where demand for

experienced private bankers was high. Performance-related remuneration rose, reflecting strong revenue growth and a 19 per cent increase in customer relationship staff. Increased marketing expenditure and technology costs were incurred in support of growing the business.

The sale of part of HSBC's interest in UTI Bank Limited resulted in gains of US\$101 million, recognised in **Other**. The disposal of Hang Seng's head office building realised a gain of US\$100 million and the resulting reduction in HSBC's investment property portfolio, together with slower growth in the Hong Kong property market, led to lower property revaluation gains.

Increased US interest rates led to higher costs of servicing US dollar denominated floating rate subordinated debt, partly offset by higher earnings on centrally held funds. In 2006, HSBC benefited from higher dividend income from strategic investments. Hong Kong head office and central IT costs rose, reflecting increased activity in support of HSBC's growing Asian businesses, offset by higher recoveries from other customer groups.

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Profit/(loss) before tax and balance sheet data by customer group and global business

## Year ended 31 December 2007

Hong Kong	Personal Financial Services US\$m	Commercial Banking US\$m	Global Banking & Markets US\$m	Private Banking US\$m	Other US\$m	Inter- segment elimination <sup>14</sup> US\$m	Total US\$m
Net interest income/(expense)	3,342	1,540	986	70	(767)	312	5,483
Net fee income	1,973	526	682	179	2	□	3,362
Trading income excluding net interest income	188	63	553	280	186	□	1,270
Net interest income on trading activities	5	□	241	□	38	(312)	(28)
Net trading income <sup>5</sup>	193	63	794	280	224	(312)	1,242
Net income/(expense) from financial instruments designated at fair value	820	(13)	7	□	(138)	□	676
Gains less losses from financial investments	□	□	38	1	55	□	94
Dividend income	2	1	6	□	22	□	31
Net earned insurance premiums	2,654	130	13	□	□	□	2,797
Other operating income	153	28	114	6	881	(337)	845
<b>Total operating income</b>	<b>9,137</b>	<b>2,275</b>	<b>2,640</b>	<b>536</b>	<b>279</b>	<b>(337)</b>	<b>14,530</b>
Net insurance claims <sup>6</sup>	(3,116)	(82)	(10)	□	□	□	(3,208)
<b>Net operating income<sup>4</sup></b>	<b>6,021</b>	<b>2,193</b>	<b>2,630</b>	<b>536</b>	<b>279</b>	<b>(337)</b>	<b>11,322</b>
Loan impairment	(175)	(28)	(28)	□	□	□	(231)

charges and  
other credit  
risk provisions

<b>Net operating income</b>	<b>5,846</b>	<b>2,165</b>	<b>2,602</b>	<b>536</b>	<b>279</b>	<b>(337)</b>	<b>11,091</b>
Total operating expenses	<b>(1,639)</b>	<b>(547)</b>	<b>(1,025)</b>	<b>(231)</b>	<b>(675)</b>	<b>337</b>	<b>(3,780)</b>
<b>Operating profit/(loss)</b>	<b>4,207</b>	<b>1,618</b>	<b>1,577</b>	<b>305</b>	<b>(396)</b>	<b>□</b>	<b>7,311</b>
Share of profit in associates and joint ventures	<b>5</b>	<b>1</b>	<b>1</b>	<b>□</b>	<b>21</b>	<b>□</b>	<b>28</b>
<b>Profit/(loss) before tax</b>	<b>4,212</b>	<b>1,619</b>	<b>1,578</b>	<b>305</b>	<b>(375)</b>	<b>□</b>	<b>7,339</b>

	<b>%</b>	<b>%</b>	<b>%</b>	<b>%</b>	<b>%</b>		<b>%</b>
Share of HSBC's profit before tax	<b>17.4</b>	<b>6.7</b>	<b>6.5</b>	<b>1.3</b>	<b>(1.6)</b>		<b>30.3</b>
Cost efficiency ratio	<b>27.2</b>	<b>24.9</b>	<b>39.0</b>	<b>43.1</b>	<b>241.9</b>		<b>33.4</b>
	<b>US\$m</b>	<b>US\$m</b>	<b>US\$m</b>	<b>US\$m</b>	<b>US\$m</b>		<b>US\$m</b>

**Balance sheet data<sup>7</sup>**

Loans and advances to customers (net)	<b>38,197</b>	<b>25,890</b>	<b>19,171</b>	<b>4,329</b>	<b>2,051</b>		<b>89,638</b>
Total assets	<b>72,386</b>	<b>35,366</b>	<b>185,933</b>	<b>14,138</b>	<b>24,868</b>		<b>332,691</b>
Customer accounts	<b>129,159</b>	<b>51,562</b>	<b>37,364</b>	<b>15,649</b>	<b>754</b>		<b>234,488</b>

The following assets and liabilities were significant to Global Banking and Markets:

□loans and advances to banks (net)	<b>53,725</b>
□trading assets, financial instruments designated at fair value, and financial investments	<b>74,189</b>
□deposits by banks	<b>6,251</b>

For footnotes, see page 130.





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HSBC HOLDINGS PLC

**Report of the Directors: Business Review**

(continued)

*Hong Kong > Profit/(loss) before tax by customer group*

Profit/(loss) before tax and balance sheet data by customer group and global business (continued)

	Year ended 31 December 2006						Total US\$m
	Personal Financial Services US\$m	Commercial Banking US\$m	Global Banking & Markets US\$m	Private Banking US\$m	Other US\$m	Inter- segment elimination <sup>14</sup> US\$m	
<b>Hong Kong</b>							
Net interest income/(expense)	2,882	1,344	553	76	(646)	476	4,685
Net fee income/(expense)	977	454	534	123	(32)	□	2,056
Trading income excluding net interest income	84	57	573	176	34	□	924
Net interest income on trading activities	4	□	88	□	77	(476)	(307)
Net trading income <sup>5</sup>	88	57	661	176	111	(476)	617
Net income/(expense) from financial instruments designated at fair value	373	(53)	5	1	(66)	□	260
Gains less losses from financial investments	14	□	(1)	9	140	□	162
Dividend income	1	1	2	□	57	□	61
Net earned insurance premiums .	2,519	95	14	□	□	□	2,628
Other operating income	202	33	81	13	781	(276)	834
<b>Total operating income</b>	<b>7,056</b>	<b>1,931</b>	<b>1,849</b>	<b>398</b>	<b>345</b>	<b>(276)</b>	<b>11,303</b>
Net insurance claims <sup>6</sup>	(2,638)	(50)	(11)	□	□	□	(2,699)
<b>Net operating income<sup>4</sup></b>	<b>4,418</b>	<b>1,881</b>	<b>1,838</b>	<b>398</b>	<b>345</b>	<b>(276)</b>	<b>8,604</b>
Loan impairment (charges)/recoveries and other credit risk provisions	(119)	(69)	27	□	(11)	□	(172)
<b>Net operating income</b>	<b>4,299</b>	<b>1,812</b>	<b>1,865</b>	<b>398</b>	<b>334</b>	<b>(276)</b>	<b>8,432</b>
<b>Total operating expenses</b>	<b>(1,422)</b>	<b>(491)</b>	<b>(911)</b>	<b>(197)</b>	<b>(524)</b>	<b>276</b>	<b>(3,269)</b>
<b>Operating profit/(loss)</b>	<b>2,877</b>	<b>1,321</b>	<b>954</b>	<b>201</b>	<b>(190)</b>	<b>□</b>	<b>5,163</b>
Share of profit in associates and joint	3	□	1	□	15	□	19

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ventures

Profit/(loss) before tax	2,880	1,321	955	201	(175)	□ 5,182
	%	%	%	%	%	%
Share of HSBC's profit before tax	13.0	6.0	4.3	0.9	(0.7)	23.5
Cost efficiency ratio	32.2	26.1	49.6	49.5	151.9	38.0
	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m
Balance sheet data <sup>7</sup>						
Loans and advances to customers (net)	35,445	23,520	20,270	3,081	1,966	84,282
Total assets	57,348	29,786	153,200	10,462	21,632	272,428
Customer accounts	118,201	41,493	24,530	11,991	476	196,691
The following assets and liabilities were significant to Global Banking and Markets:						
□ loans and advances to banks (net)			45,023			
□ trading assets, financial instruments designated at fair value, and financial investments			80,036			
□ deposits by banks			4,363			

For footnotes, see page 130.

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Year ended 31 December 2005

	Personal Financial Services US\$m	Commercial Banking US\$m	Global Banking & Markets US\$m	Private Banking US\$m	Other US\$m	Inter- segment elimination <sup>14</sup> US\$m	Total US\$m
<b>Hong Kong</b>							
Net interest income/(expense)	2,618	1,096	607	75	(529)	197	4,064
Net fee income	740	402	431	93	8	□	1,674
Trading income/(expense) excluding net interest income	67	48	601	140	(83)	□	773
Net interest income/(expense) on trading activities	□	□	(40)	□	10	(197)	(227)
Net trading income/(expense) <sup>5</sup>	67	48	561	140	(73)	(197)	546
Net income/(expense) from financial instruments designated at fair value	41	(84)	14	□	23	□	(6)
Gains less losses from financial investments	□	□	□	16	92	□	108
Dividend income	1	2	18	□	20	□	41
Net earned insurance premiums	2,238	77	19	□	□	□	2,334
Other operating income	230	35	83	13	682	(238)	805
<b>Total operating income</b>	<b>5,935</b>	<b>1,576</b>	<b>1,733</b>	<b>337</b>	<b>223</b>	<b>(238)</b>	<b>9,566</b>
Net insurance claims <sup>6</sup>	(2,016)	(34)	(9)	□	□	□	(2,059)
<b>Net operating income<sup>4</sup></b>	<b>3,919</b>	<b>1,542</b>	<b>1,724</b>	<b>337</b>	<b>223</b>	<b>(238)</b>	<b>7,507</b>
Loan impairment (charges)/recoveries and other credit risk provisions	11	(168)	7	3	1	□	(146)
<b>Net operating income</b>	<b>3,930</b>	<b>1,374</b>	<b>1,731</b>	<b>340</b>	<b>224</b>	<b>(238)</b>	<b>7,361</b>
Total operating expenses	(1,305)	(419)	(809)	(150)	(422)	238	(2,867)
<b>Operating profit/(loss)</b>	<b>2,625</b>	<b>955</b>	<b>922</b>	<b>190</b>	<b>(198)</b>	<b>□</b>	<b>4,494</b>
Share of profit in associates and joint ventures	3	□	□	□	20	□	23
<b>Profit/(loss) before tax</b>	<b>2,628</b>	<b>955</b>	<b>922</b>	<b>190</b>	<b>(178)</b>	<b>□</b>	<b>4,517</b>
	%	%	%	%	%		%
Share of HSBC's profit before tax	12.5	4.6	4.4	0.9	(0.9)		21.5
Cost efficiency ratio	33.3	27.2	46.9	44.5	189.0		38.2

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	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m
Balance sheet data <sup>7</sup>						
Loans and advances to customers (net)	34,318	20,292	23,712	3,107	1,779	83,208
Total assets	52,798	25,625	133,005	7,621	16,327	235,376
Customer accounts	105,801	37,417	21,070	9,216	222	173,726

The following assets and liabilities were significant to Global Banking and Markets:

Loans and advances to banks (net)			39,164			
Trading assets, financial instruments designated at fair value, and financial			63,813			
Investments deposits by banks			4,373			

*For footnotes, see page 130.*

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HSBC HOLDINGS PLC

**Report of the Directors: Business Review**

(continued)

*Rest of Asia-Pacific > Profit/(loss) before tax***Rest of Asia-Pacific (including the Middle East)**

Profit/(loss) before tax by country within customer groups and global businesses

	<b>Personal Financial Services US\$m</b>	<b>Commercial Banking US\$m</b>	<b>Global Banking &amp; Markets US\$m</b>	<b>Private Banking US\$m</b>	<b>Other US\$m</b>	<b>Total US\$m</b>
<b>Year to 31 December 2007</b>						
Australia	41	37	42	□	4	124
India	(70)	88	429	(1)	83	529
Indonesia	(7)	29	86	□	(4)	104
Japan	(34)	(3)	75	□	5	43
Mainland China	494	397	369	□	1,101	2,361
Associates	516	351	220	□	1,093	2,180
Other mainland China	(22)	46	149	□	8	181
Malaysia	81	90	146	□	13	330
Middle East	245	482	495	3	82	1,307
Egypt	10	46	65	□	32	153
United Arab Emirates	108	262	242	3	2	617
Other Middle East	83	101	116	□	□	300
Middle East (excluding Saudi Arabia)	201	409	423	3	34	1,070
Saudi Arabia	44	73	72	□	48	237
Singapore	101	112	240	90	7	550
South Korea	(44)	(20)	159	□	28	123
Taiwan	(52)	27	144	□	4	123
Other	5	111	279	□	20	415
	<b>760</b>	<b>1,350</b>	<b>2,464</b>	<b>92</b>	<b>1,343</b>	<b>6,009</b>

	<b>Personal Financial Services US\$m</b>	<b>Commercial Banking US\$m</b>	<b>Global Banking &amp; Markets US\$m</b>	<b>Private Banking US\$m</b>	<b>Other US\$m</b>	<b>Total US\$m</b>
<b>Year to 31 December 2006</b>						
Australia	76	32	46	□	□	154
India	(24)	46	277	2	92	393
Indonesia	(22)	46	69	□	(22)	71

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Japan	(3)	(2)	49	(1)	80	123
Mainland China	276	241	167	□	24	708
Associates	274	210	86	□	5	575
Other mainland China	2	31	81	□	19	133
Malaysia	77	87	99	(1)	12	274
Middle East	235	356	396	2	46	1,035
Egypt	9	41	41	□	20	111
United Arab Emirates	70	209	145	3	(2)	425
Other Middle East	59	67	70	(1)	(1)	194
Middle East (excluding Saudi Arabia)	138	317	256	2	17	730
Saudi Arabia	97	39	140	□	29	305
Singapore	73	90	145	68	(11)	365
South Korea	(55)	(20)	115	□	19	59
Taiwan	(179)	37	118	□	1	(23)
Other	23	121	168	10	46	368
	477	1,034	1,649	80	287	3,527

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	Personal Financial Services US\$m	Commercial Banking US\$m	Global Banking & Markets US\$m	Private Banking US\$m	Other US\$m	Total US\$m
Year to 31 December 2005						
Australia	15	25	51	□	□	91
India	(15)	21	166	□	40	212
Indonesia	15	39	55	□	4	113
Japan	□	(1)	4	3	(7)	(1)
Mainland China	42	168	111	□	13	334
Associates	36	140	58	□	4	238
Other mainland China	6	28	53	□	9	96
Malaysia	39	65	119	(1)	14	236
Middle East	208	296	297	1	19	821
Egypt	6	29	22	□	12	69
United Arab Emirates	51	171	119	1	□	342
Other Middle East	54	75	45	□	□	174
Middle East (excluding Saudi Arabia)	111	275	186	1	12	585
Saudi Arabia	97	21	111	□	7	236
Singapore	65	68	100	68	(12)	289
South Korea	(11)	(5)	97	□	13	94
Taiwan	(21)	17	74	□	(2)	68
Other	40	125	133	7	12	317
	377	818	1,207	78	94	2,574

## Loans and advances to customers (net) by country

	At 31 December		
	2007 US\$m	2006 US\$m	2005 US\$m
Australia	11,339	8,775	9,412
India	7,220	4,915	3,546
Indonesia	1,642	1,337	1,221
Japan	4,258	3,391	3,190
Mainland China	11,647	6,065	4,935
Malaysia	8,856	7,747	6,400
Middle East (excluding Saudi Arabia)	21,607	15,622	13,154
Egypt	1,853	965	774
United Arab Emirates	14,103	10,148	8,496
Other Middle East	5,651	4,509	3,884
Singapore	11,505	9,610	9,841
South Korea	7,124	6,260	5,286
Taiwan	3,658	3,974	3,817

Other	<u>12,996</u>	<u>9,878</u>	<u>9,214</u>
	<u>101,852</u>	<u>77,574</u>	<u>70,016</u>



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HSBC HOLDINGS PLC

**Report of the Directors: Business Review**

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*Rest of Asia-Pacific > Profit/(loss) before tax*

Customer accounts by country

	At 31 December		
	2007	2006	2005
	US\$m	US\$m	US\$m
Australia	11,418	8,491	7,458
India	12,021	7,936	5,146
Indonesia	2,574	2,082	1,826
Japan	4,657	4,186	5,892
Mainland China	14,537	6,941	4,826
Malaysia	11,701	9,640	7,795
Middle East (excluding Saudi Arabia)	30,937	21,196	15,658
Egypt	4,056	2,703	1,992
United Arab Emirates	18,455	11,166	8,761
Other Middle East	8,426	7,327	4,905
Singapore	28,962	23,517	19,562
South Korea	5,760	3,890	3,554
Taiwan	9,426	7,675	5,718
Other	18,240	13,441	11,683
	<b>150,233</b>	<b>108,995</b>	<b>89,118</b>

Year ended 31 December 2007 compared with year ended 31 December 2006

**Economic briefing**

**Mainland China**'s economy continued to grow strongly, with GDP rising by 11.4 per cent in 2007, the fifth consecutive year of double-digit growth; this was despite a combination of measures aimed at curbing investment, such as increases in interest rates and reserve ratios required for banks. Economic performance remained primarily dependent on investment and exports. Bank loan growth also remained very strong. Export growth slowed from very high levels as the year progressed, reflecting the mild downturn in global trade. Consumer spending grew steadily in 2007, with retail sales rising by about 16 per cent. Inflationary pressures increased, with consumer price inflation exceeding 6 per cent towards the end of the year, mainly due to higher food prices. Mainland China's foreign exchange reserves rose further, to more than US\$1.5 trillion, while the renminbi appreciated by over 5 per cent against the US dollar in 2007.

**Japan**'s economy, the largest in the region, expanded modestly in 2007. Private capital investment decelerated after five years of firm growth but a rise in exports, especially to Asia, drove overall growth. Private consumption also made a positive contribution, helped by a gradual increase in employees' income. Core consumer price inflation remained around zero throughout the course of the year.

In the **Middle East**, economies continued to grow, although growth rates slowed slightly on those recorded in 2006, largely as a result of OPEC-mandated cuts in oil production. Underlying

economic performance was robust, however, led by continued non-oil sector growth. The catalyst for expansion was a fifth consecutive year of rising oil prices, which facilitated continued growth in public and private investment. Consumption rose as employment levels increased and low interest rates supported an ongoing expansion in credit. Strong population growth, accelerated in parts of the region by high levels of immigration, also boosted demand for credit. High oil revenues resulted in a further year of fiscal and current account surpluses throughout the Middle East, boosting reserves and holdings of overseas assets. Rapid economic growth, low interest rates and currency weakness increased inflation, however, fuelling demands in some quarters for adjustments to the long-standing dollar pegs. Regional equity markets recovered from their 2005-06 downturns to perform strongly in 2007.

Elsewhere in the region, the Indian economy expanded by 8.7 per cent in 2007, although there was evidence that recent interest rate rises and the strength of the rupee were slowing some areas of the economy, and inflationary pressures eased in 2007. The economies of Vietnam and Singapore recorded strong performances too, expanding by 8.5 per cent and 7.7 per cent, respectively in 2007. Growth was approximately 6 per cent in Indonesia and Malaysia. Domestic demand in all these countries has become an increasingly important source of GDP growth with investment, particularly in the construction sector, expanding rapidly. Inflationary pressures intensified in 2007, largely as a result of higher oil and food prices, but remained under control. The South Korean economy accelerated in 2007 as exports continued to flourish and household spending recovered from levels recorded in 2006.

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## Profit before tax

	Year ended 31 December		
	2007 US\$m	2006 US\$m	2005 US\$m
<b>Rest of Asia-Pacific (including the Middle East)</b>			
Net interest income	4,143	3,047	2,412
Net fee income	2,246	1,622	1,340
Net trading income	1,643	1,181	860
Net income from financial instruments designated at fair value	111	79	58
Gains less losses from financial investments	38	41	18
Gains arising from dilution of interests in associates	1,081	□	□
Dividend income	8	5	5
Net earned insurance premiums	226	174	155
Other operating income	798	765	335
<b>Total operating income</b>	<b>10,294</b>	<b>6,914</b>	<b>5,183</b>
Net insurance claims incurred and movement in liabilities to policyholders .	(253)	(192)	(166)
<b>Net operating income before loan impairment charges and other credit risk provisions</b>	<b>10,041</b>	<b>6,722</b>	<b>5,017</b>
Loan impairment charges and other credit risk provisions	(616)	(512)	(134)
<b>Net operating income</b>	<b>9,425</b>	<b>6,210</b>	<b>4,883</b>
Total operating expenses	(4,764)	(3,548)	(2,762)
<b>Operating profit</b>	<b>4,661</b>	<b>2,662</b>	<b>2,121</b>
Share of profit in associates and joint ventures	1,348	865	453
<b>Profit before tax</b>	<b>6,009</b>	<b>3,527</b>	<b>2,574</b>
	%	%	%
Share of HSBC's profit before tax	24.8	16.0	12.3
Cost efficiency ratio	47.4	52.8	55.1
Year-end staff numbers (full-time equivalent)	88,573	72,265	55,577
Balance sheet data <sup>7</sup>			

	At 31 December		
	2007 US\$m	2006 US\$m	2005 US\$m
Loans and advances to customers (net)	101,852	77,574	70,016
Loans and advances to banks (net)	39,861	27,517	19,559
Trading assets, financial instruments designated at fair value, and financial investments	64,381	41,585	30,348
Total assets	228,112	167,668	142,014
Deposits by banks	17,560	10,323	7,439
Customer accounts	150,233	108,995	89,118

For footnote, see page 130.

Concerns over liquidity growth prompted the central bank to increase interest rates by 50 basis points to 5 per cent during the year. A gradual cooling of demand and concerns over rapid exchange rate appreciation are expected to limit the scope for further interest rate rises in 2008. Buoyant exports supported economic growth in Taiwan, while

domestic demand remained lacklustre due to a lack of government initiatives which is expected to continue beyond the presidential and parliamentary elections scheduled for 2008. Generally robust economic performances in the Philippines, Thailand, and Pakistan in 2007 were overshadowed to varying degrees by political risks.

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*Rest of Asia-Pacific > Profit/(loss) before tax***Reconciliation of reported and underlying profit before tax****Year ended 31 December 2007 compared with year ended 31 December 2006**

Rest of Asia-Pacific	2006 as reported	Currency translation <sup>1</sup>	2006 at 2007 exchange rates	Dilution gains <sup>2</sup>	Underlying change	2007 as reported	Reported change	Underlying change
	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m	%	%
Net interest income	3,047	140	3,187	□	956	4,143	36	30
Net fee income	1,622	58	1,680	□	566	2,246	38	34
Other income <sup>3</sup>	2,053	108	2,161	1,081	410	3,652	78	19
<b>Net operating income<sup>4</sup></b>	<b>6,722</b>	<b>306</b>	<b>7,028</b>	<b>1,081</b>	<b>1,932</b>	<b>10,041</b>	<b>49</b>	<b>27</b>
Loan impairment charges and other credit risk provisions	(512)	(13)	(525)	□	(91)	(616)	(20)	(17)
<b>Net operating income</b>	<b>6,210</b>	<b>293</b>	<b>6,503</b>	<b>1,081</b>	<b>1,841</b>	<b>9,425</b>	<b>52</b>	<b>28</b>
Operating expenses	(3,548)	(179)	(3,727)	□	(1,037)	(4,764)	(34)	(28)
<b>Operating profit</b>	<b>2,662</b>	<b>114</b>	<b>2,776</b>	<b>1,081</b>	<b>804</b>	<b>4,661</b>	<b>75</b>	<b>29</b>
Income from associates	865	25	890	□	458	1,348	56	51
<b>Profit before tax</b>	<b>3,527</b>	<b>139</b>	<b>3,666</b>	<b>1,081</b>	<b>1,262</b>	<b>6,009</b>	<b>70</b>	<b>34</b>

For footnotes, see page 130.

## Review of business performance

HSBC's operations in Rest of Asia-Pacific reported a pre-tax profit of US\$6.0 billion compared with US\$3.5 billion in 2006, an increase of 71 per cent. On an underlying basis, excluding dilution gains of US\$1.1 billion, profit before tax increased by 34 per cent, bolstered by sustained growth and business expansion across the region.

In Global Banking and Markets, profit before tax increased significantly, driven by an enhanced product offering combined with buoyant local markets. Commercial Banking revenue benefited from increased customer volumes as a result of new and enhanced banking services. In Personal Financial Services, profit before tax rose as a result of strong balance sheet growth and increased contributions from associates. Private Banking delivered a solid performance, underpinned by robust stock markets and increasing wealth in the region.

HSBC's three associates in mainland China, Ping An Insurance, Bank of Communications and Industrial Bank, all raised new capital in 2007 in the [A] share market in Shanghai in which HSBC is not able as a foreign investor to participate. A similar dilution gain from Techcombank, in Vietnam, was recorded in the second half of 2007. The resulting dilution of the Group's interests was considerably less than its share of the new monies raised and HSBC's results therefore include within [Other] aggregate pre-tax gains of US\$1.1 billion which should be regarded as exceptional.

The commentary that follows is on an underlying basis.

**Personal Financial Services** reported a pre-tax profit of US\$760 million, an increase of 51 per cent compared with 2006, due to significant growth in operating income and in the contribution from associates. Loan impairment charges declined slightly with the absence of the exceptional credit card losses incurred in Taiwan in 2006 largely offset by new loan impairment charges from expansion in consumer lending throughout the region. Continued investment in the region's emerging markets and in Japan resulted in a slight deterioration in the cost efficiency ratio.

Global and regional emphasis on distinctive product offerings, including HSBC Premier and HSBC Direct, as well as significant investment in branches and marketing, and growth of consumer assets in emerging markets, helped attract an additional 1.1 million active customers, bringing the total to over 9 million. 87 new branches in mainland China, India, Indonesia, the Philippines, Sri Lanka, Bangladesh and Malaysia expanded the total branch network to 410. These initiatives spurred brisk growth of the business, with double-digit revenue growth in most countries in the region.

HSBC Premier was relaunched in 22 markets in the region, extending international banking connectivity to 35 countries globally. The number of Premier customers within Rest of Asia-Pacific increased by 37 per cent.

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In mainland China, pre-tax profit grew by 71 per cent, as the share of profit from associates made significant progress. Operating income from own branded operations increased, though operating profit fell due to continuing investment expenditure in key regions within mainland China. The Chinese government's Qualified Domestic Institutional Investors (QDII) scheme, which allows mainland Chinese citizens to invest overseas, contributed to an increase in net fee income. HSBC's own-branded network expanded to 18 branches and 44 sub-branches and, following local incorporation, HSBC began full renminbi-denominated services. HSBC was the first foreign bank to qualify to provide local currency services in Beijing. New branches were added in the key economic zones of the Pearl River Delta, the Yangtze River Delta and the Bohai Rim. In addition, Hang Seng Bank added an additional three branches and seven sub-branches, bringing its total to 25 outlets. HSBC has the largest branch network among foreign banks and remained focused on offering Premier services. This led to significant deposit growth and a 51 per cent rise in the total number of customers.

In the Middle East, pre-tax profit grew strongly, other than in Saudi Arabia, and in aggregate increased by 4 per cent. Revenue growth across the region was offset by a reduced contribution from HSBC's associate in Saudi Arabia, which resulted from lower stock market-related income than the exceptional levels in 2006. Balance sheet growth continued in the UAE across core asset and liability lines, with the latter also benefiting from improved margins. Promotions were instrumental in raising credit card balances as well as related interest income and fees.

In Singapore, pre-tax profit increased by 33 per cent, largely attributable to strong sales of unit trusts, along with successful campaigns to increase credit card usage and deposit balances. Average deposit balances rose by 23 per cent compared with 2006.

In India, a pre-tax loss of US\$70 million was recorded due to planned investment in growing a consumer finance business and higher loan impairment charges. The personal lending portfolio, excluding mortgages, grew by 67 per cent during 2007. Excellent growth in operating income was achieved across all key products with 23 per cent growth in the number of active customers to over 2.4 million. HSBC is among the market leaders in India in new credit card issuance and retail mutual funds distribution. The wealth management business continued to perform strongly with a 91 per cent increase in funds under management and the number of insurance policies in force more than doubled. The

credit card business continued to expand while also delivering operating income growth of 33 per cent.

In Malaysia, revenues grew robustly as strong income growth was achieved in cards and personal lending. HSBC also recorded significant deposit growth, with balances 12 per cent higher than last year.

In Indonesia, expansion of consumer finance and development of the wealth management business helped increase revenues which, with more moderate loan impairment charges, resulted in an improvement in profitability.

In Taiwan, a pre-tax loss of US\$52 million was 70 per cent better than in 2006. Revenues and expenses were in line with the previous year, while loan impairment charges were lower due to the non-recurrence of regulatory changes.

Net interest income of US\$2.0 billion was 23 per cent higher, driven by strong growth across the region, particularly in the Middle East, India, Malaysia, the Philippines, Indonesia, mainland China, Singapore, Thailand and South Korea, due to higher balances from personal lending, credit cards and deposit accounts.

Average deposit balances rose by 23 per cent, partly as a result of the global relaunch of HSBC Premier and the addition of 136 dedicated Premier outlets, which led to notable increases in Singapore, mainland China, Malaysia, India and the Middle East. In South Korea, Taiwan and the Middle East, deposit growth was boosted by the successful launch of HSBC Direct, the Group's online savings offering, which attracted more than 376,000 accounts with total savings balances exceeding US\$1.2 billion at the end of 2007. An online savings product was also launched in the Middle East. Deposit spreads widened, particularly in India and Australia during the first half of the year, as interest rates rose in much of the region.

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Average asset balances also increased and spreads widened as the asset mix shifted towards higher margin products. Personal lending grew by 3 per cent despite the sale of mortgage portfolios in Australia in the second half of 2006 and in New Zealand in July 2007. Excluding these countries, personal lending grew by 8 per cent.

Cards in circulation rose to 8.9 million and card balances were 23 per cent higher than in 2006. Various promotional initiatives in the Middle East contributed to a 30 per cent rise in card accounts and a 62 per cent rise in balances, as card usage among consumers increased. Balances rose in India and Australia due to portfolio growth and, in the latter,



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increased use of point-of-sale financing. By the end of 2007, nearly 2.7 million credit cards were in circulation in India and over 1.2 million cards in the Middle East. In Malaysia, the Group is the third largest card issuer. Spreads in the region improved slightly due to lower funding costs.

The mortgage business in each market in Asia-Pacific was affected to varying degrees by competitive pressures on balances and margins, and by local regulatory requirements. Excluding Australia and New Zealand, which were affected by the portfolio sales, mortgage balances grew by 7 per cent. In the Middle East, mortgage balances more than doubled.

Net fee income rose by 40 per cent to US\$766 million, with increases from most products, notably cards and the wealth management businesses.

Increased sales of unit trusts and other investment products across the region was a key driver of higher fee income. Funds under management rose by 57 per cent. In the Middle East, retail sales benefited from the strong performance of local markets (largely due to sustained higher oil prices), and improved volumes of key products. Strong investment sales were recorded in India, South Korea, Singapore and mainland China, where HSBC offered residents renminbi-denominated products through its QDII offerings.

Credit card fee income increased, primarily in the Middle East, India, the Philippines and Malaysia, due to a combination of additional cards in circulation, increased spending and higher balances.

Distribution capabilities for insurance products were expanded through strategic alliances and the addition of new branches. In addition, marketing campaigns promoted HSBC's expertise in life and non-life products. As a result, insurance fees and new premiums rose by 170 per cent and 50 per cent respectively. The improved and extended sales management in the Middle East, Taiwan and India increased fees from the distribution of insurance products.

Loan impairment charges and other credit risk provisions declined by 1 per cent. Loan impairment charges were significantly lower in Taiwan due to the non-recurrence of regulatory measures which, in 2006, had led to an increase in loan impairment charges. In Indonesia, lower impairment charges were a result of an improved economic environment and continued collection efforts. The Middle East businesses benefited from lower delinquencies and better collections.

In India, higher loan impairment charges were due to volume growth of the portfolio, along with a change in the collection methods of staff and agencies and regulatory restrictions on collections. Loan impairment charges in Malaysia also increased. In Thailand, loan impairment charges rose from a previously low level, partly because of the one-off effect of a regulatory increase during the year in the minimum payment due on credit cards.

Ongoing expansion in the region led to increases in headcount and performance-related staff costs, particularly in mainland China and the Middle East, which contributed to a 27 per cent increase in operating expenses to US\$2.1 billion. Staff numbers rose from 750 to nearly 1,900 in mainland China, primarily in new branches. In India, an additional 700 employees were added to drive business expansion, bringing the total to over 4,600. Additional staff in the Middle East were concentrated in the UAE, where the number of employees

increased from nearly 1,200 to 1,500, reflecting investment in the region.

Investment expenditure during 2007 was focused on implementing new business initiatives in consumer finance, HSBC Direct and expansion in mainland China. In India, the consumer finance branch network and the credit card business were expanded. In Indonesia, HSBC added 36 consumer finance loan centres. In mainland China, key cities were identified for increased investment and a total of 27 new branches and sub-branches were opened.

Income from HSBC's strategic investments in its associates increased by 45 per cent, predominantly due to an increased contribution from Ping An Insurance, which experienced steady growth in its key business segments as well as improved investment returns. In the Middle East, Saudi British Bank's performance was lower than in 2006, as the local stock market did not reach the volume of activity seen in that year.

**Commercial Banking** reported a profit before tax of US\$1.4 billion, 27 per cent higher than in 2006. The region's economies performed strongly, and this generated excellent trade and investment flows. The launch of secure and enhanced online banking services, and new International Banking Centres established to support the increase in the customer base, contributed to strengthened deposit growth. Costs rose to fund investment in expansion in mainland China and India, initiatives directed at small and medium-sized businesses in selected countries and additional employee numbers to support this planned growth. The cost efficiency ratio was largely in line with 2006.

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In the Middle East, operating profit grew by 29 per cent, underpinned by strong economic growth and the success of new International Banking Centres and dedicated Business Banking Centres. Small-business banking was introduced in Bahrain, Qatar and Jordan. In the UAE, additional relationship managers in the business banking unit helped to drive a 30 per cent increase in revenues. The region performed well, particularly in deposits and trade-related lending.

Operating profit grew by 56 per cent in mainland China to US\$46 million, reflecting growing lending volumes to mid-market customers and improved spreads on lending products. Lending volume growth resulted in part from increased cross-border activity, new branches and additional front-line employees.

In Singapore, profit before tax rose by 19 per cent, driven by higher net interest income from balance sheet growth. Enhancements to the receivables finance offering contributed to strong growth in fee income.

In India, profit before tax grew by 76 per cent. Growth was broadly based with both net interest income and net fee income registering healthy increases of 78 per cent and 57 per cent, respectively. Net interest income rose from wider asset spreads and balance sheet growth, driven by selective lending related to the booming Indian real estate sector. Higher foreign exchange volumes and treasury product sales drove growth in fee income.

Revenues in Malaysia rose by 9 per cent, again due to strong balance sheet growth, further supported by initiatives to grow deposit balances and complemented by improved liability margins. Lending rose, particularly due to corporate term lending, but competition resulted in narrower spreads. Results in 2006 benefited from net recoveries on loan impairment charges which did not recur.

Cross-border activity was facilitated in part through the cross-border referral system, Global Links, which was extended across most of the region. Regional alignments and the acceleration of cross-border activity led to an 87 per cent increase in successful referrals. A further 19 International Banking Centres were opened in 2007, taking the coverage to 26 of the region's countries and territories.

Net interest income grew by 29 per cent to US\$1.1 billion. The opening of new branches, an increased commercial presence supported by call centres, and the enhancement of BIB in Asia-Pacific contributed to customer acquisition, particularly in

mainland China, Malaysia, Vietnam and Mauritius, spurring deposit and loan growth.

The UAE drove a strong increase in net interest income in the Middle East. Deposits and lending each recorded substantial volume growth as the region continued to experience high levels of investment and business expansion which buoyed local economic activity. Trade flows in the region also benefited small and medium-sized businesses and their related deposits. Trade-related lending rose by 45 per cent.

In India, net interest income grew by 78 per cent, largely due to trade-related lending products in combination with growth in deposits. Both lending and deposits benefited from an increase in the number of frontline sales staff in provincial cities. Net interest income from small and medium-sized businesses rose by 49 per cent. Increased margins on current accounts reflected the higher interest rates in the region. Local incorporation in Mauritius allowed closer alignment with HSBC in India.

In mainland China, net interest income rose by 79 per cent as the opening of new branches and recruitment of additional frontline employees succeeded in attracting new deposits and additional sales of lending products. HSBC utilised country desks to facilitate a greater number of cross-border transactions with South Korea, Vietnam, Hong Kong and Taiwan, which partly contributed to the 68 per cent growth in commercial lending volumes. The widening of liability spreads also contributed to net interest income growth.

Net interest income also rose strongly in Singapore and Malaysia, mainly due to higher deposit balances. In Malaysia, improvements to direct channels helped to generate increased balances in current accounts, and spreads rose accordingly. Growth in South Korea was partly the result of the successful acquisition of new customers.

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Net fee income increased by 26 per cent, largely due to the continued growth of trade services, particularly in the Middle East, and cross-border transaction fees in India.

Trade-related lending fees rose by 24 per cent. The majority of this increase arose in the Middle East, where intra-regional trade flows increased as a result of strong economic performance. In India, customer acquisition of SME businesses, in combination with higher volumes of transactions from existing customers, increased trade-related fees by 81 per cent. TradeSmart in Malaysia and Tradeline in Bangladesh were among the initiatives used to maintain HSBC's reputation for providing

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strong support for small and medium-sized business trade.

Fees generated from small and micro businesses rose as the customer base increased, in part due to customer acquisition campaigns, enhanced internet banking capabilities and the acquisition of Chailease, a factoring company in Taiwan which facilitates cross-border transactions.

Trading income increased by 45 per cent, as volatility among Asian currencies resulted in increased business flows and higher volumes. Volatile exchange rates also drove demand for hedging products, leading to an improvement in foreign exchange earnings, particularly in India and Singapore. Additional volumes were driven by the launch of an online trading platform. In the Middle East, trading income rose due to higher demand from customers for foreign exchange and interest rate hedging products.

Loan impairment charges were US\$61 million compared with a net release in 2006. The charges mainly arose in Thailand and Indonesia, largely due to portfolio growth and a small number of delinquent customer accounts. The overall increase in loan impairment charges was balanced by recoveries in the UAE, Singapore and Mauritius.

Total operating expenses grew by 28 per cent, as growth was supplemented by investment in branch expansion in India and mainland China, and small-business initiatives in the Middle East. Additional staff were recruited to support sales growth, business initiatives and general expansion. In mainland China, HSBC established a rural bank targeting micro borrowers. Continued emphasis on the use of lower cost delivery media resulted in a substantial rise in the number of customers registered for BIB; the number of transactions undertaken through internet channels was 4 million, an increase of 127 per cent compared with 2006.

Income from associates rose by 64 per cent. Bank of Communications and Industrial Bank in mainland China substantially increased their contributions compared with 2006, largely due to balance sheet growth.

**Global Banking and Markets** reported a record pre-tax profit of US\$2.5 billion in Rest of Asia-Pacific, an increase of 44 per cent on 2006. Robust growth across most revenue lines was driven by the successful delivery of HSBC's global products to clients throughout the region, against a backdrop of rapid growth in regional economies and continuing international and domestic investor confidence in local stock markets. In line with the strategy to build

an emerging markets-led and financing-focused business, there were strong revenue performances in Global Banking and Markets in India, mainland China, the Middle East, Singapore and Malaysia, which more than offset a 26 per cent increase in operating expenses. The cost efficiency ratio improved by 3.0 percentage points to 34.5 per cent. Total operating income increased by 37 per cent to US\$3.3 billion with growth of over 20 per cent in all major countries, led by securities services, balance sheet management and foreign exchange trading.

Net interest income grew by 54 per cent, reflecting balance sheet growth and improved spreads compared with the first half of 2006. In an environment of buoyant local markets and favourable deposit spreads, payments and cash management and balance sheet management reported notable increases across the region, particularly in mainland China, Singapore and India. In the Middle East, growth in income was driven by higher liability balances and improved spreads.

Net fee income rose by 34 per cent to US\$952 million with good performances throughout the region in securities services, driven by a sustained level of transaction volumes and investment flows. In securities services, assets under custody increased by 83 per cent, due to the successful transfer of Westpac's sub-custody clients in Australia and New Zealand, and high market volumes, particularly in India. Additionally, there was especially high fee income in Singapore, particularly from financing and capital markets, and payments and cash management.

HSBC Global Asset Management income grew by 68 per cent, following continued success in distributing emerging market funds to the Japanese market and a second year of strong performance fees from BRIC (Brazil, Russia, India and China) funds generating growth in Singapore.

A significant rise in trading income was mainly due to record revenues from foreign exchange trading, driven by increased customer flows as a result of volatility in exchange rates against the US dollar across the region. Rates trading also contributed, benefiting from favourable market conditions in most countries.

Operating expenses increased by 26 per cent, mainly in the Middle East, Singapore, India and mainland China. Increased technology and infrastructure costs were incurred in support of business expansion initiatives. Higher staff costs reflected increases in employee numbers and performance-related pay in response to robust growth in operating income.

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The share of profits in associates and joint ventures increased by 47 per cent, reflecting higher contributions from HSBC's investments in Bank of Communication, Industrial Bank and Ping An Insurance, largely due to balance sheet growth.

**Private Banking** reported a pre-tax profit of US\$92 million, an increase of 15 per cent. Strong revenue growth was achieved in Singapore, with further improvements in Japan, underpinned by buoyant stock markets and rapidly expanding wealth across the region. However, this was offset by increases in operating expenses, with the result that the cost efficiency ratio worsened by 2.8 percentage points to 57.6 per cent.

Net interest income rose by 71 per cent to US\$60 million, mainly due to increased lending volumes in Singapore and improved treasury performance, as US dollar and Hong Kong dollar interest rates declined.

In Singapore, increased client appetite for discretionary portfolios and the SIS multi-manager product contributed to the 23 per cent increase in net fee income.

Trading income marginally decreased, with increased demand for structured products being offset by higher funding costs.

Client assets grew by 21 per cent to US\$20.3 billion, with strong growth in Singapore and Japan. Net new money of US\$2.2 billion was mainly attributable to the recruitment of additional relationship managers and a wider range of discretionary products.

Operating expenses were up by 29 per cent to US\$125 million. The majority of the rise was in Singapore, as a result of increased employee numbers, particularly in the front office, and alignment of salaries to market conditions to support future growth. Also contributing to the rise were operating expenses in India, which more than doubled as HSBC continued to build its Private Banking business there.

In **Other**, GSC activity increased substantially as the number of countries using service centres rose to 31 from 24 in 2006. Costs rose by 40 per cent to US\$790 million following the opening of six new GSCs and the resultant increase in staff and administrative costs, all of which were recovered in the form of other operating income from HSBC's customer groups.

Year ended 31 December 2006 compared with year ended 31 December 2005

### **Economic briefing**

**Mainland China's** economy continued to grow strongly, with GDP rising by 10.7 per cent in 2006, the fourth consecutive year of double-digit growth. Despite the government's stated intention of promoting consumption in favour of investment growth, economic performance remained primarily dependent on investment and exports. However, some success was achieved in this respect, as urban fixed-asset investment slowed significantly to about 22 per cent in the second half of 2006 from 31 per cent in the first half of the year. This resulted from a combination of measures, including several interest rate rises, increases in banks' required reserve ratios, and the draining of liquidity via bill sales and 'window guidance', the exercise of influence by the authorities over the banks on policy matters, such as slowing lending growth.

Export growth remained strong, accelerating slightly during the second half of 2006 despite evidence of slower global growth. Although a slowdown in the US growth rate in 2007 could negatively affect mainland China's exports, the slowdown in investment spending referred to above provides the authorities with the scope to ease policy and stimulate domestic spending if exports falter. Consumer spending rose steadily in 2006 with retail sales rising by about 13 per cent, and bank loans continued to grow rapidly. The inflationary environment remained benign, with consumer prices rising by less than 2 per cent. Mainland China's foreign exchange reserves rose to above US\$1 trillion, the world's highest level. The currency appreciated gradually against the US dollar, with an increase of over 3 per cent in 2006.

**Japan's** economy, the largest in the region, grew in 2006. Export growth was steady despite a slight slowing in the second half of the year, and private capital investment remained firm, driven by record levels of corporate profits and the need to upgrade the capital stock to maintain global competitiveness. Consumer spending was disappointing, however, and was the major reason why GDP growth was less than expected. Core consumer prices generally rose.

Economic growth in the **Middle East** remained robust over the second half of the year, continuing a strong expansionary phase that HSBC estimates will result in GDP in the Gulf region doubling in the space of just four years. Buoyed by high oil prices and strong production, earnings from energy reached record highs in 2006. Strong revenue growth encouraged government spending across the region,



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particularly on capital projects. Private investment, from both domestic and foreign sources, was also high while abundant liquidity, rising employment and rapid population growth supported further increases in private consumption. Although interest rates rose, tracking those in the US over the course of the year, credit growth continued to be strong. Robust domestic demand and the weakness of the US dollar boosted inflationary pressures. Following corrections in the first half of 2006, the major regional stock exchange indices continued to trade at significant discounts to the record levels registered in late 2005, with markets remaining generally sluggish.

Elsewhere in the region, most economies continued to perform impressively, particularly India, Singapore and Vietnam. The main drivers of growth

were exports, demand for technology, and domestic consumption, with investment demand lagging behind. India was among the strongest performing economies in the world, with GDP growth of about 9 per cent in 2006. This led to some signs of overheating, with inflation rising during the year. The Reserve Bank of India responded by raising interest rates, and there may be more increases to come. GDP in Singapore grew by 8 per cent in 2006, in Vietnam by over 7 per cent and in Malaysia by approximately 6 per cent, their economies benefiting from generally low inflation and strong domestic and external demand. Most Asian currencies ended 2006 stronger than the US dollar. A US slowdown is a risk for the region.

**Reconciliation of reported and underlying profit before tax**

Year ended 31 December 2006 compared with year ended 31 December 2005

	2005		2005		2006		Reported change	Underlying change
	as reported	Currency translation <sup>1</sup>	at 2006 exchange rates	Acquisitions and disposals <sup>2</sup>	Underlying change	as reported		
<b>Rest of Asia-Pacific</b>	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m	%	%
Net interest income	2,412	30	2,442	□	605	3,047	26	25
Net fee income	1,340	1	1,341	□	281	1,622	21	21
Other income <sup>3</sup>	1,265	21	1,286	□	767	2,053	62	60
<b>Net operating income<sup>4</sup></b>	<b>5,017</b>	<b>52</b>	<b>5,069</b>	<b>□</b>	<b>1,653</b>	<b>6,722</b>	<b>34</b>	<b>33</b>

Loan impairment charges and other credit risk provisions	(134)	(3)	(137)	□	(375)	(512)	(282)	(274)
Net operating income	4,883	49	4,932	□	1,278	6,210	27	26
Operating expenses	(2,762)	(22)	(2,784)	□	(764)	(3,548)	(28)	(27)
Operating profit	2,121	27	2,148	□	514	2,662	26	24
Income from associates	453	4	457	159	249	865	91	54
Profit before tax	2,574	31	2,605	159	763	3,527	37	29

For footnotes, see page 130.

### Review of business performance

HSBC's operations in Rest of Asia-Pacific delivered a pre-tax profit of US\$3.5 billion compared with US\$2.6 billion in 2005, an increase of 37 per cent. On an underlying basis, pre-tax profits grew by 29 per cent, with the major change in composition of the Group being the additional 10 per cent stake purchased in Ping An Insurance in August 2005 which made that company a 19.9 per cent owned associate of HSBC.

Pre-tax profits in the region have nearly doubled in the past two years, justifying HSBC's strategy of investing in emerging markets. Momentum in 2006 was strong, with underlying net operating income increasing by 26 per cent, notwithstanding a

significant rise in loan impairment charges arising primarily from industry-wide credit deterioration in the credit card portfolio in Taiwan, mainly in the first half of 2006. Significant increases in total operating income and pre-tax profits were reported in the Middle East, India, Singapore and Malaysia. In Taiwan, HSBC launched the direct savings proposition which had been received very positively in the US. HSBC's strategic investments in mainland China, Bank of Communications and Industrial Bank, contributed to a 54 per cent underlying increase in income from associates.

The commentary that follows is on an underlying basis.

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**Personal Financial Services** reported a pre-tax profit of US\$477 million, 16 per cent lower than in 2005. Strong operating trends were masked by a US\$160 million rise in loan impairment charges in Taiwan, which suffered from regulatory changes introduced to address high levels of consumer indebtedness. Pre-provision operating income increased by 29 per cent, driven by balance sheet growth, wider deposit spreads and increased fee income. Income growth was supported by business development activity which contributed to a 26 per cent increase in operating costs. The cost efficiency ratio improved by 1.3 percentage points.

The development of HSBC's regional business continued apace, and double digit profit growth was achieved in 5 sites, namely the Middle East, mainland China, Malaysia, Singapore and the Philippines. Customer numbers increased by 1.5 million, or 21 per cent, to 8.9 million, through strong growth in the credit card business, increased marketing activity and expansion of the sales force. 36 new branches and 28 consumer loan centres were opened in 13 countries, most notably Indonesia, mainland China and the Middle East, and at the end of 2006, HSBC had 396 branches in Rest of Asia-Pacific region and 7.3 million cards in issue.

Net interest income increased by 24 per cent to US\$1.6 billion. Average asset and liability balances grew strongly, while interest rate rises contributed to a 31 basis point widening of deposit spreads. Asset spreads were in line with 2005.

Average deposit balances rose by 16 per cent to US\$34.4 billion, principally due to growth in the HSBC Premier customer base. Development of the Premier business was supported by a concerted customer acquisition campaign which included regional and local advertising and the establishment of new, dedicated Premier centres. Overall deposit balance growth was especially strong in Singapore, the Middle East and mainland China. In Singapore, promotional campaigns, which included a deposit product sale, contributed to a 23 per cent increase in liability balances while, in the Middle East, HSBC ran a deposit raising campaign with new product launches, marketing and internal sales incentives, leading to a 20 per cent rise in average deposit balances. In mainland China, growth in HSBC Premier, which accompanied the opening of 12 new Premier sub-branches, contributed to higher deposit balances.

Average loans and advances to customers rose by 16 per cent, driven by higher credit card advances and increased mortgage balances. Average card balances increased by 22 per cent to US\$3.1 billion,

reflecting higher cardholder spending and a 21 per cent increase in cards in circulation. Over 2.5 million cards were issued during 2006, with new products launched in the Middle East, Sri Lanka and Singapore. HSBC ran marketing and incentive campaigns in a number of countries and card balances rose substantially in Malaysia, the Middle East, Indonesia, India and the Philippines.

Average mortgage balances increased by 13 per cent to US\$18.9 billion, reflecting robust growth in Singapore, Taiwan, India and Malaysia. In Singapore, HSBC used targeted promotional rates to build market share and this, together with increased marketing activity, contributed to a 25 per cent increase in mortgage balances. In Taiwan, competitive pricing and customer retention initiatives contributed to a rise in customer numbers and resulted in a 22 per cent increase in average mortgage balances. In India, mortgage balances rose by 27 per cent, benefiting from increased marketing and direct sales efforts, while in Malaysia, the successful promotion of Homsmart, a flexible offset mortgage product, enabled HSBC to increase average mortgage balances by 10 per cent and widen spreads in a highly competitive market.

Personal lending balances increased by 22 per cent, partly as a result of significant growth in HSBC's consumer finance business in India, Australia and Indonesia. In Indonesia, HSBC opened 28 dedicated consumer finance outlets while, in India, 25 new outlets were opened in branches. In Australia, consumer finance was developed in partnership with well known international retailers such as IKEA and Bang & Olufsen, together with established local retailers including Clive Peeters and Bing Lee. HSBC signed a number of exclusive supplier agreements with retailers and, as a result, the number of retail distribution outlets grew to more than 1,100, which enabled HSBC to increase its market share. In Malaysia, the success of HSBC's instalment loan product, Anytime Money, which was relaunched in 2005, contributed to a 93 per cent rise in average personal lending balances. In the Middle East, HSBC focused on promoting a select portfolio of products following a product simplification exercise instigated in the fourth quarter of 2005 which led to a 22 per cent rise in personal lending balances. Investments in HSBC's South Korean operations had immediate results and personal lending balances more than doubled.

Net fee income rose by 24 per cent to US\$524 million. Regional card fees were 30 per cent higher, reflecting solid growth in cardholder spending while, in Indonesia, higher card fee income was a consequence of a rise in delinquencies.

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The robust performance of regional stock markets during 2006 contributed to strong demand for investment products and led to the launch of new investment funds, which together generated a 27 per cent increase in investment fee income, including custody and broking fees. Growth was particularly strong in South Korea, Taiwan, India and Singapore. Sales of investment products, including unit trusts, bonds and structured products, increased by 19 per cent to US\$8.0 billion and funds under management grew by 19 per cent to US\$8.6 billion.

HSBC continued to develop its regional insurance business by launching medical insurance in Singapore and establishing a Takaful joint venture in Malaysia, offering *shariah*-compliant insurance products. In the Middle East, cardholder credit insurance was launched in the fourth quarter of 2006. These product launches were supported by increased marketing activity and targeted investment to increase HSBC's presence and market share. Consequently, the number of policies in force at the end of 2006 rose by 89 per cent to 800,000 and insurance fee income and insurance premiums rose by 12 per cent and 4 per cent respectively.

Other operating income increased by US\$71 million due to gains on the sale of HSBC's Australian stockbroking, margin lending and mortgage broker businesses. Additionally, HSBC established a joint venture with Global Payments Inc. to manage the majority of the bank's Asian card acquiring business. This was transferred to the joint venture in July 2006, realising a gain of US\$10 million in the region's Personal Financial Services business.

Loan impairment charges and other credit risk provisions more than doubled to US\$545 million, mainly due to higher charges for personal lending in Taiwan and Indonesia. In Taiwan, regulatory changes restricted collection activities and eased repayment terms for delinquent borrowers. These changes, coupled with a deteriorating credit environment, led to a US\$160 million increase in loan impairment charges related mainly to the credit card portfolio, most of which were realised in the first half of 2006. In Indonesia, changes in minimum repayment amounts, along with hardship following a significant reduction in the government subsidy of fuel prices, led to increased delinquency rates on credit cards, also mainly in the first half of 2006. Elsewhere in the region, credit quality was broadly stable and growth in impairment charges followed increases in credit card and personal lending balances.

Operating expenses increased by 26 per cent to US\$1.6 billion, largely tracking revenue growth.

Expansion of the branch network and development of sales and support functions led to higher staff numbers and, together with higher performance-related incentive payments, contributed to a rise in staff costs. The new branch openings increased premises and equipment costs. The establishment of a number of consumer finance businesses and HSBC Direct's introduction in Taiwan were also factors in the rise of operating expenses.

Marketing costs rose as HSBC increased advertising and promotional activity directed to attracting new customers, enlarging HSBC's share of the credit card, mortgage and unsecured personal lending markets and increasing deposit balances. In the Middle East, IT expenditure rose as HSBC introduced a new internet banking infrastructure, implemented HSBC's WHIRL credit card system and made major updates to customer relationship management software.

Largely driven by a strong performance in HSBC's strategic investment in Ping An Insurance, which reported record results in 2006, income from associates rose by 59 per cent. In Saudi Arabia there were buoyant revenues from stock trading and investment business, particularly in the first half of 2006 although, subsequently,

turbulent local stock markets affected investor sentiment and contributed to lower income in the second half of the year.

**Commercial Banking** reported a pre-tax profit of US\$1.0 billion, 25 per cent higher than in 2005. Pre-provision operating income increased by 25 per cent, driven by higher deposit and lending balances and widening liability spreads. The migration of routine activities to lower-cost channels helped to mitigate business expansion costs, and operating expenses consequently increased by 21 per cent. The cost efficiency ratio improved by 1.4 percentage points.

During 2006, HSBC focused on developing its cross-border business banking activities and increasing its presence in the small business market, supported by investment in delivery channels and increased promotional activity. International business banking benefited from the strong performance of HSBC's two regional alignment programmes, centred on mainland China and the Middle East, together with the establishment of International Business Centres in seven sites including Australia, mainland China, India and Taiwan. In addition, new branches in mainland China, India, Malaysia, Bangladesh and Sri Lanka were complemented by enhancements to internet banking services in Malaysia and India and improved self-service terminals in a number of countries. The launch of

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HSBC's inaugural global Commercial Banking advertising campaign, increased local marketing activity and the realisation of business development teams throughout the Asia-Pacific region contributed to an 8 per cent increase in Commercial Banking customer numbers to 177,000, with particularly strong growth in Malaysia, mainland China and India.

Net interest income rose by 33 per cent to US\$848 million. Higher customer numbers contributed to increased average asset and liability balances, while interest rate rises led to wider liability spreads, partly offset by narrower asset spreads.

Interest rate rises also contributed to higher demand for deposit products and liability balances increased in a number of countries, most notably the Middle East, Singapore, Taiwan, Malaysia and India. In the Middle East, HSBC successfully initiated a targeted marketing campaign offering preferential savings rates to selected customers while, in Singapore and Taiwan, enhanced sales incentives contributed to growth in liability balances. In Malaysia, expansion of the branch network together with fresh marketing campaigns, competitive pricing and product enhancements increased customer numbers and led to a 31 per cent rise in average liability balances. In India, current account and deposit balances increased by 40 per cent, partly from liquidity chasing new IPOs, which surged in line with strong local equity markets.

In 2006, HSBC successfully launched a number of initiatives designed to increase asset balances throughout the Rest of Asia-Pacific region to deploy the additional deposit base being attracted. For example, in Malaysia, television and press advertising helped trigger a 31 per cent increase in average non-trade lending balances. Trade and Save marketing campaigns launched in Malaysia and India in the wake of higher regional trade flows, offered customer incentives designed to expand HSBC's market share in trade lending. Targeted incentive programmes were also launched in Singapore, Sri Lanka, mainland China, South Korea and Indonesia. In the Middle East, strong demand for credit underpinned by robust economic expansion resulted in a 26 per cent rise in average lending balances.

Net fee income rose by 7 per cent to US\$330 million as volume-related increases in trade fees were recorded in the Middle East and India. HSBC in India also benefited from higher fees from lending activities, reflecting growth in the number of borrowing customers, while payments and cash management fee income rose in the Middle East.

Trading income increased by 25 per cent. In the Middle East, HSBC continued to invest in its Commercial Banking treasury business to support an increasingly international customer base. As customer demands became more sophisticated, 15 new products were launched in 2006, while higher marketing activity and the establishment of an online e-trading platform also contributed to a rise in customer trading volumes. Increased hedging activity among Commercial Banking customers also led to increased foreign exchange earnings in India and Malaysia.

The transfer of the majority of HSBC's Asian card acquiring business into a joint venture with Global Payments Inc. led to the recognition of a gain of US\$10 million in Commercial Banking, reported in "Other operating income".

Strong economic conditions supported a further net release of loan impairment charges, which decreased by 57 per cent compared with 2005. Underlying credit quality remained strong.

Operating expenses increased by 21 per cent to US\$554 million in support of business expansion. HSBC recruited additional sales and support staff, increased its Commercial Banking presence in the branch network and committed to higher marketing activity in a number of countries, most notably the Middle East, India and mainland China. Strong revenue growth resulted in higher performance payments and this, together with salary inflation, added to rising staff costs. In South Korea, the Commercial Banking business expansion proceeded as planned, staff numbers more than doubled, and HSBC incurred higher premises, equipment and infrastructure costs as a consequence. In the Middle East, increased business volumes necessitated systems improvements which resulted in higher IT costs.

Income from HSBC's strategic investments in associates increased by 47 per cent. Income from Bank of Communications rose by 45 per cent as a result of higher asset and liability balances, effective credit control and improvements in the cost efficiency ratio, while income from Industrial Bank was 55 per cent higher. In the

Middle East, net releases of loan impairments, following net charges in 2005, led to strong growth in Commercial Banking income in The Saudi British Bank.

**Global Banking and Markets** delivered a record pre-tax profit of US\$1.6 billion, an increase of 35 per cent compared with 2005. Positive revenue trends were reported across most countries, reflecting continued growth in HSBC's wholesale banking businesses in emerging markets. The Middle East,



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HSBC HOLDINGS PLC

## **Report of the Directors: Business Review** (continued)

### *Rest of Asia-Pacific > 2006*

India, Taiwan and Singapore accounted for 66 per cent of the increase in pre-tax profits. The cost efficiency ratio improved by 3.5 percentage points to 37.6 per cent.

Total operating income increased by 29 per cent compared with 2005 to US\$2.3 billion. In Global Markets, the securities services business benefited from investment flows into and within emerging markets, leading to higher customer volumes in buoyant local markets.

In Global Banking, payments and cash management services increased in all countries, with significant contributions from businesses in India, the Middle East, Singapore and mainland China reflected in higher net interest income. The strength of domestic economies within emerging markets, coupled with the global trend of rising interest rates, drove deposit balances and improvements in spreads. Corporate lending income in the Middle East increased by 33 per cent as economic growth continued and infrastructure investment rose. These gains were partly offset by lower balance sheet management revenues.

Net fee income increased by 38 per cent to US\$688 million. A significant increase in fee income in Global Markets was driven by higher securities services business volumes, reflecting improved investment sentiment and buoyant local markets, particularly in early 2006. Debt underwriting volumes increased, particularly in the Middle East, as lower credit spreads encouraged issuers to lock into the favourable credit environment by extending the term of finance or raising new debt in local markets.

In Global Banking, income from the advisory business was boosted by a steady flow of new deals, driven by the strong momentum provided by economic development in the Middle East. Trade finance and payments and cash management fee income also benefited from higher customer volumes.

HSBC Global Asset Management revenues more than doubled, reflecting higher funds under management and performance fees on emerging market funds.

Net trading income of US\$717 million rose by 26 per cent, benefiting from an increasing interest rate environment and volatile foreign exchange markets. Although, generally, volatility levels were lower than those experienced in 2005, the emerging market correction in May 2006 combined with a rapid recovery in the second half of the year to stimulate a rise in foreign exchange and Credit and Rates volumes in most countries. HSBC also

benefited from higher foreign investment flows as investor confidence in the improved stability of emerging economies grew. In the second half of 2006, growth in revenues from retail structured investment products moderated as investors sought outright exposure to equities, and deposit yields improved. However, in the Middle East, there was strong demand for structured interest rate products among corporate and institutional customers and for risk management advisory products as clients continued to hedge exposures.

Gains on the disposal of financial investments were higher than in 2005, largely due to income from the sale of debt securities in the Philippines in 2006, together with the non-recurrence of losses on the disposal of US dollar securities in Japan in January 2005.

The net recovery in loan impairment charges declined significantly due to the non-recurrence of a large recovery in Malaysia in 2005.

Operating expenses increased by 18 per cent to US\$869 million, in part due to an increase in performance-related incentives which reflected the robust growth in operating income. In the Middle East and India, higher staff costs also arose from additional recruitment to support the expansion of capabilities across various businesses.

In Global Markets, support costs increased in line with higher transaction volumes and greater product complexity, while a rise in payments and cash management activity, primarily in HSBC's operations in India, mainland China, Singapore, South Korea and Indonesia, resulted in higher operational expense.

The share of profits in associates increased by 47 per cent, primarily reflecting higher contributions from HSBC's investments in Bank of Communications in mainland China and The Saudi British Bank.

**Private Banking** reported a pre-tax profit of US\$80 million, a modest increase compared with 2005. Revenue growth was strong across the region despite challenging market conditions, particularly in Singapore, with notable contributions from the onshore Private Banking operations launched in the Middle East and India during 2005. Employee benefits rose at a faster rate than revenue, driven by a fiercely competitive market for experienced private banking staff, and this led to a deterioration of the cost efficiency ratio from 50.7 per cent in 2005 to 54.5 per cent in 2006. Net interest income grew by 21 per cent to US\$35 million. Growth was predominantly in

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Singapore, where treasury performance improved and unfavourable positions unwound, and India, where the recently launched business was successful in attracting deposits.

Fee income increased by 62 per cent to US\$68 million, with significant growth in Singapore, India and the Middle East. Initiatives to attract clients to HSBC's suite of discretionary managed products, particularly the SIS and CIS products, proved successful.

Trading and other operating income was slightly lower than in 2005, due to sluggish stock market performance and correspondingly subdued client activity.

Client assets increased by 12 per cent to US\$16 billion, benefiting from the recruitment of front office staff, client appetite for investment in newly launched funds and the successful growth of recently launched onshore businesses in the region.

Investment in funds benefited from higher demand for HSBC and third party manager funds, including the SIS and CIS products in which the value of client investments grew to US\$291 million. Higher deposits and investments in equities also contributed to the growth in client assets.

Operating expenses increased by 25 per cent, reflecting continued investment in the onshore Japanese operations and growth of the business in India. Staff costs rose as competition for front-office professionals intensified, putting upward pressure on staff rewards, and the full-year impact of the expansion in staff recruitment in 2005 fed through.

HSBC sold properties in Japan and India, realising gains of US\$87 million in **Other**, US\$77 million higher than in 2005. Costs and recoveries in the GSCs both rose, reflecting increased activity supported by higher staff numbers. Interest rate rises and higher retained earnings led to a doubling of earnings on centrally held funds.

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HSBC HOLDINGS PLC

## Report of the Directors: Business Review

(continued)

*Rest of Asia-Pacific > Profit before tax by customer group*

Profit before tax and balance sheet data by customer group and global business

Year ended 31 December 2007

Rest of Asia-Pacific (including the Middle East)	Personal	Commercial	Global	Private	Other	Inter-	Total
	Financial Services	Banking	Banking & Markets	Banking		segment elimination <sup>14</sup>	
	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m
Net interest income	1,965	1,131	1,295	60	153	(461)	4,143
Net fee income	766	429	952	85	14	□	2,246
Trading income/(expense) excluding net interest income	72	129	1,000	71	(70)	□	1,202
Net interest income/(expense) on trading activities	(2)	□	(22)	□	4	461	441
Net trading income/(expense) <sup>5</sup>	70	129	978	71	(66)	461	1,643
Net income/(expense) from financial instruments designated at fair value	73	4	(3)	(1)	38	□	111
Gains less losses from financial investments	5	4	28	□	1	□	38
Gains arising from dilution of interests in associates	□	□	□	□	1,081	□	1,081
Dividend income	□	□	2	□	6	□	8
Net earned insurance premiums	209	16	□	□	1	□	226
Other operating income/(expense)	40	15	53	2	849	(161)	798
	<b>3,128</b>	<b>1,728</b>	<b>3,305</b>	<b>217</b>	<b>2,077</b>	<b>(161)</b>	<b>10,294</b>

<b>Total operating income</b>							
Net insurance claims <sup>6</sup>	(246)	(7)	□	□	□	□	(253)
<b>Net operating income<sup>4</sup></b>							
	2,882	1,721	3,305	217	2,077	(161)	10,041
Loan impairment charges and other credit risk provisions	(552)	(61)	(3)	□	□	□	(616)
<b>Net operating income</b>							
	2,330	1,660	3,302	217	2,077	(161)	9,425
Total operating expenses	(2,131)	(739)	(1,140)	(125)	(790)	161	(4,764)
<b>Operating profit</b>							
	199	921	2,162	92	1,287	□	4,661
Share of profit in associates and joint ventures	561	429	302	□	56	□	1,348
<b>Profit before tax</b>							
	760	1,350	2,464	92	1,343	□	6,009
	%	%	%	%	%		%
Share of HSBC's profit before tax	3.1	5.6	10.2	0.4	5.5		24.8
Cost efficiency ratio	73.9	42.9	34.5	57.6	38.0		47.4
	US\$m	US\$m	US\$m	US\$m	US\$m		US\$m
<b>Balance sheet data<sup>7</sup></b>							
Loans and advances to customers (net)	34,486	32,159	32,106	2,955	146		101,852
Total assets	40,092	37,215	133,814	7,561	9,430		228,112
Customer accounts	49,703	34,891	54,120	11,116	403		150,233
The following assets and liabilities were significant to Global Banking and Markets:							
□ loans and advances to banks (net)			30,853				
□ trading assets, financial instruments designated at fair value, and financial			59,222				

investments	
□ deposits by banks	<b>17,174</b>

*For footnotes, see page 130.*

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Year ended 31 December 2006

<b>Rest of Asia-Pacific (including the Middle East)</b>	Personal		Global			Intersegment	Total
	Financial Services	Commercial Banking	Banking & Markets	Private Banking	Other	elimination <sup>14</sup>	US\$m
	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m
Net interest income	1,520	848	802	35	61	(219)	3,047
Net fee income	524	330	688	68	12	□	1,622
Trading income/(expense) excluding net interest income	61	86	717	74	(3)	□	935
Net interest income on trading activities	□	□	□	□	27	219	246
Net trading income <sup>5</sup>	61	86	717	74	24	219	1,181
Net income from financial instruments designated at fair value	59	4	4	□	12	□	79
Gains less losses from financial investments	2	2	38	(1)	□	□	41
Dividend income	□	□	1	□	4	□	5
Net earned insurance premiums .	148	26	□	□	□	□	174
Other operating income	108	20	61	□	667	(91)	765
<b>Total operating income</b>	<b>2,422</b>	<b>1,316</b>	<b>2,311</b>	<b>176</b>	<b>780</b>	<b>(91)</b>	<b>6,914</b>
Net insurance claims <sup>6</sup>	(180)	(11)	□	□	(1)	□	(192)
<b>Net operating income<sup>4</sup></b>	<b>2,242</b>	<b>1,305</b>	<b>2,311</b>	<b>176</b>	<b>779</b>	<b>(91)</b>	<b>6,722</b>
Loan impairment (charges)/ recoveries and other credit risk provisions	(545)	29	5	□	(1)	□	(512)
<b>Net operating income</b>	<b>1,697</b>	<b>1,334</b>	<b>2,316</b>	<b>176</b>	<b>778</b>	<b>(91)</b>	<b>6,210</b>
<b>Total operating expenses</b>	<b>(1,593)</b>	<b>(554)</b>	<b>(869)</b>	<b>(96)</b>	<b>( 527)</b>	<b>91</b>	<b>(3,548)</b>
<b>Operating profit</b>	<b>104</b>	<b>780</b>	<b>1,447</b>	<b>80</b>	<b>251</b>	<b>□</b>	<b>2,662</b>
Share of profit in associates and joint ventures	373	254	202	□	36	□	865
<b>Profit before tax</b>	<b>477</b>	<b>1,034</b>	<b>1,649</b>	<b>80</b>	<b>287</b>	<b>□</b>	<b>3,527</b>

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	%	%	%	%	%	%
Share of HSBC's profit before tax	2.2	4.7	7.5	0.4	1.2	16.0
Cost efficiency ratio	71.1	42.5	37.6	54.5	67.7	52.8
	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m

Balance sheet data<sup>7</sup>

Loans and advances to customers (net)	28,911	21,912	24,311	2,313	127	77,574
Total assets	35,317	26,335	93,605	6,476	5,935	167,668
Customer accounts	38,557	24,228	36,623	8,929	658	108,995

The following assets and liabilities were significant to Global Banking and Markets:

□ loans and advances to banks (net)

22,171

□ trading assets, financial instruments designated at fair value, and financial investments

36,580

□ deposits by banks

9,849

For footnotes, see page 130.



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HSBC HOLDINGS PLC

**Report of the Directors: Business Review**

(continued)

Rest of Asia-Pacific > Profit before tax by customer group /  
North America

Profit before tax and balance sheet data by customer group and global business (continued)

Year ended 31 December 2005

Rest of Asia-Pacific (including the Middle East)	Personal	Commercial	Global	Private	Other	Inter-	Total
	Financial	Banking	Banking	Banking		segment	
	Services		& Markets			elimination <sup>14</sup>	
	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m
Net interest income	1,208	631	614	30	54	(125)	2,412
Net fee income	419	307	498	43	73	□	1,340
Trading income/(expense) excluding net interest income	37	70	579	74	(7)	□	753
Net interest income/(expense) on trading activities	1	(1)	(21)	□	3	125	107
Net trading income/(expense) <sup>5</sup>	38	69	558	74	(4)	125	860
Net income from financial instruments designated at fair value	44	1	4	□	9	□	58
Gains less losses from financial investments	□	4	12	2	□	□	18
Dividend income	□	□	1	□	4	□	5
Net earned insurance premiums .	134	21	□	□	□	□	155
Other operating income	37	9	82	4	287	(84)	335
<b>Total operating income</b>	<b>1,880</b>	<b>1,042</b>	<b>1,769</b>	<b>153</b>	<b>423</b>	<b>(84)</b>	<b>5,183</b>
Net insurance claims <sup>6</sup>	(157)	(9)	□	□	□	□	(166)
<b>Net operating income<sup>4</sup></b>	<b>1,723</b>	<b>1,033</b>	<b>1,769</b>	<b>153</b>	<b>423</b>	<b>(84)</b>	<b>5,017</b>
Loan impairment (charges)/ recoveries and other credit risk provisions	(236)	67	35	2	(2)	□	(134)

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Net operating income	1,487	1,100	1,804	155	421	(84)	4,883
Total operating expenses	(1,245)	(452)	(733)	(77)	( 339)	84	(2,762)
Operating profit	242	648	1,071	78	82	□	2,121
Share of profit in associates and joint ventures	135	170	136	□	12	□	453
Profit before tax	377	818	1,207	78	94	□	2,574
	%	%	%	%	%		%
Share of HSBC's profit before tax	1.8	3.9	5.8	0.4	0.4		12.3
Cost efficiency ratio	72.3	43.8	41.4	50.3	80.1		55.1
	US\$m	US\$m	US\$m	US\$m	US\$m		US\$m
Balance sheet data <sup>7</sup>							
Loans and advances to customers (net)	27,433	18,694	21,431	2,347	111		70,016
Total assets	32,224	22,570	76,026	5,359	5,835		142,014
Customer accounts	31,250	18,612	32,102	7,092	62		89,118
The following assets and liabilities were significant to Global Banking and Markets:							
loans and advances to banks (net)			15,352				
trading assets, financial instruments designated at fair value, and financial investments			26,113				
deposits by banks			7,041				
<i>For footnotes, see page 130.</i>							

[Back to Contents](#)**North America**

Profit/(loss) before tax by country within customer groups and global businesses

	<b>Personal Financial Services US\$m</b>	<b>Commercial Banking US\$m</b>	<b>Global Banking &amp; Markets US\$m</b>	<b>Private Banking US\$m</b>	<b>Other US\$m</b>	<b>Total US\$m</b>
<b>Year ended 31 December 2007</b>						
United States	(1,824)	377	(1,243)	156	1,468	(1,066)
Canada	265	466	239	8	5	983
Bermuda	13	77	39	10	34	173
Other	□	□	□	□	1	1
	<b>(1,546)</b>	<b>920</b>	<b>(965)</b>	<b>174</b>	<b>1,508</b>	<b>91</b>
<b>Year ended 31 December 2006</b>						
United States	3,128	442	199	107	(264)	3,612
Canada	253	437	189	□	17	896
Bermuda	10	78	31	7	29	155
Other	□	□	4	□	1	5
	<b>3,391</b>	<b>957</b>	<b>423</b>	<b>114</b>	<b>(217)</b>	<b>4,668</b>
<b>Year ended 31 December 2005</b>						
United States	3,853	447	373	104	158	4,935
Canada	310	403	154	□	(12)	855
Bermuda	18	42	43	□	19	122
Other	□	□	3	□	□	3
	<b>4,181</b>	<b>892</b>	<b>573</b>	<b>104</b>	<b>165</b>	<b>5,915</b>

Loans and advances to customers (net) by country

	At 31 December		
	<b>2007 US\$m</b>	2006 US\$m	2005 US\$m
United States	<b>233,706</b>	236,188	216,078
Canada	<b>53,891</b>	39,584	34,453
Bermuda	<b>2,263</b>	2,215	2,033
	<b>289,860</b>	277,987	252,564

Customer accounts by country

At 31 December

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	<b>2007</b>	2006	2005
	<b>US\$m</b>	US\$m	US\$m
United States	<b>100,034</b>	84,560	76,786
Canada	<b>37,061</b>	28,668	25,643
Bermuda	<b>8,078</b>	7,694	8,957
	<b>145,173</b>	120,922	111,386

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HSBC HOLDINGS PLC

**Report of the Directors: Business Review**

(continued)

North America &gt; Profit before tax / 2007

Profit before tax

	Year ended 31 December		
	2007 US\$m	2006 US\$m	2005 US\$m
<b>North America</b>			
Net interest income	14,847	14,268	13,295
Net fee income	5,810	4,766	3,952
Net trading income/(expense)	(542)	1,358	885
Net income/(expense) from financial instruments designated at fair value	1,750	(63)	434
Gains less losses from financial investments	245	58	47
Dividend income	105	85	41
Net earned insurance premiums	449	492	477
Other operating income	360	922	642
<b>Total operating income</b>	<b>23,024</b>	<b>21,886</b>	<b>19,773</b>
Net insurance claims incurred and movement in liabilities to policyholders	(241)	(259)	(232)
<b>Net operating income before loan impairment charges and other credit risk provisions</b>	<b>22,783</b>	<b>21,627</b>	<b>19,541</b>
Loan impairment charges and other credit risk provisions	(12,156)	(6,796)	(4,916)
<b>Net operating income</b>	<b>10,627</b>	<b>14,831</b>	<b>14,625</b>
Total operating expenses	(10,556)	(10,193)	(8,758)
<b>Operating profit</b>	<b>71</b>	<b>4,638</b>	<b>5,867</b>
Share of profit in associates and joint ventures	20	30	48
<b>Profit before tax</b>	<b>91</b>	<b>4,668</b>	<b>5,915</b>
	%	%	%
Share of HSBC's profit before tax	0.4	21.1	28.2
Cost efficiency ratio	46.3	47.1	44.8
Year-end staff numbers (full-time equivalent)	52,722	55,642	53,608
Balance sheet data <sup>7</sup>			

At 31 December

	2007 US\$m	2006 US\$m	2005 US\$m
Loans and advances to customers (net)	289,860	277,987	252,560
Loans and advances to banks (net)	16,566	17,865	10,331
Trading assets, financial instruments designated at fair value, and financial investments <sup>16</sup>	133,998	145,700	112,225

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Total assets	<b>510,092</b>	511,190	432,490
Deposits by banks	<b>16,618</b>	11,484	7,780
Customer accounts	<b>145,173</b>	120,922	111,386

*For footnotes, see page 130.*

Year ended 31 December 2007 compared with year ended 31 December 2006

**Economic briefing**

In the **US**, GDP growth in 2007 was 2.2 per cent, 0.7 percentage points less than that recorded in 2006 as the housing-led downturn gathered pace. Consumer spending in 2007 grew by 2.9 per cent, the weakest annual expansion since 2003. Housing activity continued to weaken in 2007, with residential investment falling by 17 per cent during the year. Both new and existing home sales also declined to new lows in 2007. The unemployment rate averaged 4.6 per cent in 2007, with the average

in the second half of the year slightly higher at 4.8 per cent. The trade deficit narrowed in 2007 as export growth strengthened. Consumer price inflation averaged around 4 per cent in the final quarter of 2007. This was largely due to higher energy prices; excluding food and energy, consumer price inflation averaged 2.3 per cent in the fourth quarter. The Federal Reserve lowered short-term interest rates by 100 basis points in the second half of 2007, from 5.25 per cent to 4.25 per cent, as policymakers attempted to mitigate the worst effects of the sub-prime related credit squeeze upon economic activity. 10-year note yields reached a high of 5.3 per cent in June 2007, before falling to

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4 per cent by the year-end. Declines in the final months of 2007 left the Standard & Poor's S&P500 stock market index practically unchanged compared with the end of 2006.

**Canadian** GDP increased by 2.4 per cent during the first eleven months of 2007 compared with the equivalent period of 2006. Domestic demand remained strong despite tighter credit conditions in the latter part of the year, supported by the robust

labour market. The unemployment rate averaged 6 per cent for the year, reaching a historical low of 5.8 per cent in October. After hitting a high of 2.5 per cent in April, core consumer price inflation slowed to 1.5 per cent by the end of 2007. The Canadian dollar appreciated during the year, particularly in the second half. In July, the Bank of Canada raised its overnight interest rate from 4.25 per cent to 4.5 per cent before reversing this move in the final weeks of 2007.

**Reconciliation of reported and underlying profit before tax****Year ended 31 December 2007 compared with year ended 31 December 2006**

	<b>2006 as reported</b>	<b>Currency translation<sup>1</sup></b>	<b>2006 at 2007 exchange rates</b>	<b>Acquisitions, disposals and dilution gains<sup>2</sup></b>	<b>Underlying change</b>	<b>2007 as reported</b>	<b>Reported change</b>	<b>Underlying change</b>
<b>North America</b>	<b>US\$m</b>	<b>US\$m</b>	<b>US\$m</b>	<b>US\$m</b>	<b>US\$m</b>	<b>US\$m</b>	<b>%</b>	<b>%</b>
Net interest income	14,268	65	14,333	□	514	14,847	4	4
Net fee income	4,766	26	4,792	□	1,018	5,810	22	21
Other income <sup>3</sup>	2,593	10	2,603	20	(497)	2,126	(18)	(19)
<b>Net operating income<sup>4</sup></b>	<b>21,627</b>	<b>101</b>	<b>21,728</b>	<b>20</b>	<b>1,035</b>	<b>22,783</b>	<b>5</b>	<b>5</b>
Loan impairment charges and other credit risk provisions	(6,796)	(3)	(6,799)	□	(5,357)	(12,156)	(79)	(79)
<b>Net operating income</b>	<b>14,831</b>	<b>98</b>	<b>14,929</b>	<b>20</b>	<b>(4,322)</b>	<b>10,627</b>	<b>(28)</b>	<b>(29)</b>
Operating expenses	(10,193)	(47)	(10,240)	(26)	(290)	(10,556)	(4)	(3)
<b>Operating profit</b>	<b>4,638</b>	<b>51</b>	<b>4,689</b>	<b>(6)</b>	<b>(4,612)</b>	<b>71</b>	<b>(98)</b>	<b>(98)</b>
Income from associates	30	1	31	□	(11)	20	(33)	(35)

<b>Profit before tax</b>	<b>4,668</b>	<b>52</b>	<b>4,720</b>	<b>(6)</b>	<b>(4,623)</b>	<b>91</b>	<b>(98)</b>	<b>(98)</b>
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For footnotes, see page 130.

### Review of business performance

HSBC's operations in North America experienced a significant fall in pre-tax profits of 98 per cent in 2007, on both reported and underlying bases.

It is now clear that the US housing market is undergoing a significant correction and recovery is not likely in 2008. The US economy began to slow in the fourth quarter and recent evidence suggests that some parts of the country may already be in recession. As the housing market slump has affected the real economy, the deterioration in credit quality that began in the mortgage services business has extended to include other consumer finance businesses in the US. In HSBC, this was reflected in a 79 per cent rise in loan impairment charges and a loss before tax of US\$1.5 billion in Personal Financial Services.

A loss of US\$965 million in Global Banking and Markets arose from credit-related and liquidity event write-downs as asset-backed securities markets became illiquid and credit spreads widened markedly. Increased revenues in Commercial

Banking were the result of balance sheet growth achieved from the continued expansion of the business, although this revenue growth only partially offset rises in expenses and loan impairment charges. Private Banking profits rose significantly as a result of the launch of services in Canada, improved performances in the US and Bermuda and the non-recurrence of a significant loan impairment charge in 2006.

The commentary that follows is on an underlying basis.

**Personal Financial Services** reported a pre-tax loss of US\$1.5 billion, a decline of US\$4.9 billion from 2006. Performance was significantly affected by rising loan impairment charges in the consumer finance business in mortgage lending, cards and branch personal lending. Actions taken to manage exposure and realign the business in response to changes in the market included stopping new purchases in mortgage services, tightening underwriting criteria, restricting the product range in consumer lending, decreasing



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### North America > 2007

credit lines and reducing the volume of balance transfers in credit cards, and restructuring the consumer lending branch network by closing some 400 branches of HSBC Finance to reflect expected lower demand. These measures gave rise to restructuring charges of US\$103 million in the US in 2007.

US pre-tax losses of US\$1.8 billion were predominantly due to higher loan impairment charges, trading losses in the wholesale mortgage origination business and lower income from fewer receivables in the correspondent mortgage services business. In line with industry trends, the credit quality of loans weakened steadily throughout the year, particularly those underwritten in 2005, 2006 and the first half of 2007.

In Canada, profit before tax rose by 2 per cent to US\$265 million, benefiting from the strong local economy. Of this, the retail bank generated US\$116 million, including an US\$8 million gain on the sale of shares in the Montreal Exchange. Consumer finance operations added US\$149 million through balance sheet expansion in the first part of the year, prior to a fourth quarter restructuring to align with changes in the US consumer finance operation.

Net interest income grew by 1 per cent to US\$13.2 billion as growth in card and average deposit balances marginally offset a fall in US deposit margins. In the US, net interest income rose by 1 per cent as the mix of business changed to higher yielding activity and HSBC raised rates on new consumer finance mortgages to reflect increased risk. The beneficial effect on yields was, however, more than offset by the impact of non-performing assets and a higher cost of funds. Higher volumes of non-performing loans constrained revenue. Fewer mortgages repaid early as refinancing activity declined substantially, and this also resulted in lower prepayment penalties. These factors combined to limit HSBC's ability to pass on in full the increased cost of funds in a higher average rate environment. This led to an overall decline in spreads.

In the US, average deposit balances were 19 per cent higher, reflecting growth in the online savings account and certificate of deposit products. A competitively priced special promotional rate offer in the first quarter of 2007 led to 147,000 new account openings and US\$5 billion of new balances during the year, offset in part by decreases in money market term deposits. At 31 December 2007, online savings balances with HSBC Direct stood at US\$11.5 billion, held by more than 620,000 customers. HSBC Premier customer numbers rose

by 16 per cent. Deposit spreads tightened, reflecting a change in the product mix from lower-paying savings accounts to the higher-paying offerings available online and in branches. HSBC Bank USA opened 26 new branches during the year.

The slowdown in the US housing market first noted in 2006 accelerated in 2007, with further deterioration in sales of new and existing homes and lower new-build activity. Market surveys showed a broad-based decline in house prices, especially for larger loans and in states that had experienced the fastest rates of house price appreciation in recent years. Average US mortgage balances declined by 2 per cent to US\$123 billion.

Average mortgage balances originated through the consumer lending branch network rose by 18 per cent, primarily driven by lower levels of repayments and the severe contraction in market capacity, which drove qualifying borrowers to the few remaining market participants. Actions taken by HSBC to restrict the product range, increase collateral requirements, raise prices and close or consolidate about 400 branches of HSBC Finance during 2007 combined to curb lending growth towards the end of the year.

Yields on consumer lending mortgages declined overall due to increases in delinquency, loan modifications (which deferred scheduled moves to higher rates) and levels of non-performing loans, and decreases in repayments, which resulted in reduced prepayment penalties. Interest spreads narrowed as funding costs rose.

In the mortgage services business, average balances declined by 14 per cent to US\$43 billion, reflecting HSBC's decision to wind down this book in response to the deterioration in market conditions. Spreads fell, driven by higher non-performing loans and increased funding costs.

HSBC Bank USA's average mortgage balances fell by 9 per cent to US\$31 billion. HSBC continued to sell down new loan originations to government-sponsored enterprises and private investors and, with the exception of certain products, did not replace the existing portfolio being run-off. Interest rate spreads on the prime mortgage portfolio declined, primarily due to loan portfolio run off.

Average credit card balances increased by 14 per cent to US\$29 billion. Volumes in the sub-prime and near-prime portfolios rose due to additional marketing to this segment in late 2006 and the first half of 2007. Expansion slowed during the second half of 2007 as HSBC restricted growth in customer loans and advances in light of the

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economic outlook. Beginning in the third quarter of 2007, HSBC decreased marketing expenditure in an effort to slow the growth of balances in the credit card portfolio. In the fourth quarter of 2007, to further slow this growth, HSBC slowed the rate of new account acquisition, tightened the criteria for authorising initial credit lines and for underwriting credit line increases, closed inactive accounts, decreased credit lines, reduced balance transfer volume and restricted access to cash. Excluding the one-off increase from a methodology change for effective interest on introductory rate credit card loans which increased yields in 2006, yields improved due both to repricing and a change in the product mix towards a higher proportion of sub-prime and near-prime balances, coupled with lower levels of promotional balances. Spreads widened on an underlying basis as rate increases preceded any rise in funding costs.

In retail services, average balances rose by 4 per cent to US\$17 billion, driven by organic growth and the deepening of HSBC's relationships with existing partners. Spreads widened as higher yields on promotional balances (due to fewer people choosing to pay balances during the introductory period), and the benefit of price increases more than offset higher funding costs. Risk mitigation measures enacted included the tightening of credit across selected retail businesses, especially the power sports sector, closure of inactive accounts and a reduction in the limits for certain other accounts.

Average vehicle loan balances grew by 5 per cent to US\$13 billion despite the adverse effect on the motor vehicle market of higher interest rates, rising fuel prices and reduced incentive programmes from manufacturers. The main driver of growth was the successful expansion of the consumer direct channel, with online and direct sales rising by 52 per cent. Refinancing volumes were higher due to pricing and increased operational capacity. Interest rate spreads tightened as a result of a shift in portfolio mix toward higher credit quality loans.

Average balances in personal non-credit card loans rose by 4 per cent, with actions taken to reduce risk including a reduction in direct mail campaigns, the withdrawal of the personal homeowner loan product in September 2007, and tightening underwriting criteria. As a result balances declined towards the end of 2007. Spreads tightened as the benefits of a shift in mix to higher yielding products were offset by rising levels of non-performing loans, which reduced yields, and increased funding costs.

In Canada, net interest income rose by 14 per cent due to asset and deposit growth, partly offset by competitive margin compression. Average deposit balances rose by 8 per cent as the rollout of the new high-rate and direct savings accounts continued. These products added US\$935 million in new balances and some 11,900 in incremental customer numbers. HSBC Premier recorded a rise in customer numbers of 19,000. Deposit spreads were broadly unchanged as the effects of a change in mix to higher paying high-rate and direct savings products were offset by the benefits of an increased proportion of higher yielding deposits.

Average lending balances in Canada rose by 9 per cent as the strength of the economy and buoyant housing market drove demand for loans. While asset spreads at both the retail bank and the consumer finance business narrowed due to competitive pressure, overall spreads widened due to the increased proportion of higher yielding consumer finance products. Credit expansion was across all segments with the consumer finance operations achieving growth in their real estate secured, private label and credit card portfolios.

Net fee income rose by 24 per cent to US\$4.6 billion, mainly from the US credit cards and retail services businesses, reflecting growth in balances. In the US, net fee income rose by 25 per cent, largely from higher late, overlimit and Intellicheck fees in the credit card book. Revenues from enhancement services also rose, primarily from higher sales of services to new and existing customers, growth in balances and an increase in new accounts. In the fourth quarter of 2007, HSBC changed fee practices on credit cards to ensure they fully reflected HSBC's brand principles. This reduced income by US\$55 million in 2007 and is expected to have a full year effect of up to approximately US\$250 million in 2008.

Taxpayer financial services generated fee income of US\$247 million, 4 per cent lower than in the previous year due to changes in contractual terms which increased partner payments, and lower Internal Revenue Service receipts. Following a strategic review, pre-season and pre-file products and cross-collections were discontinued with effect from the beginning of the 2008 tax season.

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Fee income in Canada rose by 3 per cent on higher investment administration fees from growth in funds under management, higher fees from the Immigrant Investor Programme, higher credit fees and service charges from credit expansion and increased foreign exchange income. This was partly offset by lower retail brokerage fees.

At the US retail bank, net fee income rose by 14 per cent to US\$320 million, driven by increases

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in servicing fees on mortgages, credit card fees and deposit service charges.

Trading losses in 2007 were US\$215 million compared with trading income of US\$274 million in 2006. Conditions in the housing market meant that sub-prime mortgages could not be securitised, which led to significantly wider credit spreads and a considerable loss of market liquidity across all asset-backed securities classes. These two factors, the loss of liquidity and wider credit spreads, resulted in substantial reductions in the value of mortgages held for sale. In light of this, HSBC closed Decision One, its wholesale mortgage business, in the second half of 2007.

Gains less losses from financial instruments rose to US\$176 million from US\$14 million in 2006, due to the sale of MasterCard Inc. shares following its IPO.

Other operating income fell by 109 per cent. Losses on foreclosed properties rose due to the combined effect of an increase in the stock of such properties and a reduction in their value due to falling prices. Total foreclosed assets rose to US\$1.0 billion from US\$670 million in 2006. The fall in other operating income also reflected a US\$123 million gain in 2006 (from the sale of HSBC's investment in Kanbay, a global IT services firm) which did not recur in 2007.

Loan impairment charges and other credit risk provisions rose by 78 per cent to US\$11.9 billion. US loan impairment charges rose by 79 per cent as the deterioration in housing credit markets extended to affect loans of all product types and vintages, particularly loans originated in 2005, 2006 and the first half of 2007. The combination of reduced financing options for consumers and weak or falling property values had a significant impact on delinquency levels. Developments in the credit markets have raised fundamental concerns about the viability of the [originate and distribute] business model for securitising residential mortgages. The resulting industry-wide tightening of underwriting criteria, and the elimination of many loan products previously offered to consumers, reduced the general availability of credit and borrowers' ability to refinance. This, in turn, exacerbated house price falls, most notably in those areas which had seen the most rapid appreciation in recent years.

Lower house prices reduced the equity which customers had in their homes, removing a key source of accessible funds and reducing customers' capacity to deal with unexpected problems such as

unemployment or illness. Bankruptcy levels also increased from the exceptionally low levels seen in 2006 which followed changes in bankruptcy legislation in 2005.

In mortgage services, loan impairment charges rose by 41 per cent to US\$3.1 billion. Due to the factors noted above, delinquencies increased at a higher rate than was expected from normal portfolio seasoning<sup>1</sup>, particularly for second lien customers.

In consumer lending, loan impairment charges rose by 139 per cent to US\$4.1 billion as evidence of credit quality deterioration was seen across the loan portfolio in the second half of 2007, in particular on first lien loans originated in 2006. There was also increased delinquency on second lien loans purchased between 2004 and the third quarter of 2006. Lower run-offs of loans, growth in average lending balances, normal seasoning and a rise in bankruptcy filings to historically more usual levels after the exceptional decline in 2006, also contributed to the

rise. There was a marked increase in loan delinquency in those states most affected by the fall in home values.

Credit card impairment charges rose by 83 per cent to US\$2.8 billion as a result of weaker economic trends, growth in balances, normal portfolio seasoning, a rise in bankruptcy rates closer to historical levels, and a shift in mix to a higher proportion of non-prime loans.

Loan impairment charges in Canada rose by 38 per cent, in line with the rise in loan balances and seasoning of the vehicle finance and credit card portfolios. In addition, an impairment charge on non-bank asset-backed commercial paper (□ABCP□) was recognised in 2007.

Operating expenses rose by 2 per cent to US\$7.6 billion. In the US, while origination costs fell as loan growth was curtailed, additional resources were deployed to collection activities and the retail bank added selectively to its branch distribution network. Within the consumer finance operations, restructuring costs in 2007 totalled US\$103 million, following the decision to reposition the US consumer finance business, the closure of the wholesale mortgage services business and the reduction in the number of branches in the US consumer lending network to around 1,000 to align with the level of demand expected in light of the Group's revised risk appetite. The retail bank incurred higher staff costs due to expansion of the branch network, higher average salaries due to normal annual pay increases, and a change in mix of

1 *□Seasoning□ describes the emergence of credit loss patterns in portfolios over time.*

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staffing to support business growth initiatives. Also contributing was US\$70 million of one-off costs arising from the indemnification agreement with Visa ahead of the company's planned IPO.

Marketing costs to support the growth in Personal Financial Services lending increased in 2007, but in the second half expenditure on credit cards, co-branded credit cards and personal non-credit card marketing declined following the decision to slow loan growth in these portfolios. In HSBC Bank USA, marketing costs rose as a result of campaigns promoting the online savings product and investment in the HSBC brand, including the Newark Airport branding and the HSBC Premier relaunch. The expansion of the bank branch network in existing and new geographical areas also increased premises and other branch operating costs.

In Canada, operating expenses increased by 13 per cent due to the strategic growth of the branch network, marketing to support new products, related investment in systems, and higher transaction costs caused by the rise in customer numbers. Staff numbers, premises and equipment costs rose, partly due to the opening of five new branches. Marketing costs rose too, principally due to direct savings and brand awareness campaigns. The Canadian consumer finance business restructured its business model to align with changes in the US consumer finance operations, reducing lending through its branch network and closing the correspondent mortgage business. A total of 29 consumer finance branches were closed.

**Commercial Banking's** pre-tax profits of US\$920 million declined by 6 per cent compared with 2006. In the US, loan and deposit balances grew with the continuing expansion of the branch network outside its traditional base into 16 of the top 25 business centres by the end of the year, complemented by a restructuring of the branch sales force. Despite this growth, overall performance declined as business expansion costs, restructuring costs, lower gains on asset disposals, a slowdown in commercial and real estate activity and a deterioration in the credit environment more than offset the benefit of higher volumes.

In Canada, profit before tax was broadly flat at US\$466 million, driven by strong balance sheet growth, notwithstanding the wider funding and liquidity pressures which arose from the freezing of the non-bank ABCP market in Canada in August.

In the US, net interest income rose by 10 per cent to US\$804 million, driven by average deposit growth of 20 per cent and loan growth of 6 per cent. Organic expansion underpinned the increase, with

recently opened offices in Chicago, Washington DC and the West Coast contributing to growth. Net interest income growth slowed as a result of declining commercial real estate activity, with higher repayments and slower replacement business reflecting market conditions and credit appetite. There were also narrower spreads on deposits, as customers migrated to higher yielding products.

Average deposit balances in the US rose by 20 per cent, led by a 21 per cent increase in volumes from small business customers. The expansion of the network and targeted marketing initiatives were key factors in the rise. Spreads narrowed as the product mix changed towards higher yielding accounts, particularly among small business customers, partly offsetting the gains to income from higher balances.

Average loan balances in the US were 4 per cent higher. Loan growth was primarily due to strong activity in middle market lending, up 20 per cent, with growth coming equally from existing branches and geographic expansion. Overall loan growth was, however, much lower as a result of a slowdown in financing commercial real estate activity, where lending volumes fell by 6 per cent. Competitive pressures led to narrower spreads.

In Canada, net interest income rose by 14 per cent, driven by strong loan growth, particularly in Western Canada. Average deposit balances rose by 10 per cent, with volumes lifted by the success of the payments and cash management business. Spreads rose as repricing initiatives on key products offset the effects of competitive pressures and increased funding costs over the last four months of 2007, due to the disruption caused to the ABCP market by constrained liquidity, as described above.

Average lending balances rose by 17 per cent, buoyed by the strong economic backdrop. There was notable expansion in Western Canada, where the resource economy continued to underpin performance. Spreads were tighter due to spread compression on floating rate loans.

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In Bermuda, net interest income increased by 15 per cent. Average deposit balances fell by 6 per cent, mainly due to lower than expected growth in volumes of fixed term deposits.

Net fee income was broadly unchanged at US\$338 million. In the US, fee income was flat compared with 2006. The growth in deposit accounts and a focus on business debit cards for small and micro businesses led to a rise in deposit service charges and card fees. This was, however, offset by lower fees on the syndication of commercial real estate loans as balance activity declined. In Canada,



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fee income rose with the increase in activity volumes. Higher service charges and credit fees were the main fee generators.

Loan impairment charges rose by 151 per cent to US\$191 million, reflecting the growth in the loan book. In the US, loan impairment charges rose by 91 per cent, mainly due to the higher probability of default among commercial real estate loans and a change in methodology for loan impairment allowances on a small business revolving loan portfolio. Several condominium development projects took longer to complete than intended, resulting in cash flow issues for some customers. This hindered their ability to obtain a mortgage at the end of the construction phase which, in some cases, precipitated downgrades by ratings agencies, all of which combined to generate increased impairment charges. In Canada, loan impairment charges increased due to exposures to certain sectors affected by the strength of the Canadian dollar. An impairment charge for non-bank ABCP was also taken. The risk reflected the historically low impairment charges incurred in 2006.

Operating expenses rose by 8 per cent to US\$893million. US costs rose by 9 per cent as the expansion of the branch network led to higher staff and administration costs. Costs for collection activities also rose. In Canada, costs rose by 2 per cent due to an increase in headcount, higher staff incentives, increases in business licenses, taxes, and higher cheque clearing costs in line with rises in business activity levels. The tight labour market added upward pressure on staff costs and created challenges in filling vacancies, particularly in Western Canada.

**Global Banking and Markets** in North America reported a pre-tax loss of US\$965 million, compared with a profit of US\$423 million in 2006. Improvements across most businesses were overwhelmed by significant losses in mortgages, mortgage-backed securities and structured credit products held for trading, which were driven by widening credit spreads following the deterioration in credit markets in the second half of 2007. In addition, leveraged and acquisition finance recorded write-downs on underwriting positions held.

Total operating income of US\$645 million was 69 per cent lower than 2006, reflecting the impact of the above-mentioned losses and write-downs, partly offset by higher net interest income from corporate lending and increased deposit balances in payments and cash management.

The 38 per cent rise in net interest income partly reflected increased lending driven by client demand and higher outstanding unsyndicated loan balances in financing and capital markets.

Payments and cash management delivered a 43 per cent increase in net interest income as a result of growth in demand deposits, and a 15 per cent increase in transaction fees as higher volumes were generated from a wider range of product offerings.

Net fee income was 6 per cent ahead of 2006. Apart from the growth in payments and cash management referred to above, a strong performance in HSBC Global Asset Management reflected favourable market conditions in the first half of the year.

Trading losses of US\$734 million compared with income of US\$818 million in 2006. The decline was driven by write-downs in credit and structured derivatives, as detailed above, including US\$282 million relating to monoline exposures, of which those below investment grade have been fully written down. These losses were only

partly offset by strong foreign exchange revenues where trading volumes benefited from market volatility and positioning against a weakening US dollar. Trading income from the rates business also increased, driven by investor demand for lower risk products.

The credit market dislocation also led to an adverse fair value adjustment for loan commitments outstanding when global credit spreads widened in the second half of the year. Including this and the credit and structured derivatives write-downs referred to above, the total write-down was US\$1.4 billion.

The benign corporate credit environment experienced in recent years continued and impairment charges were low, albeit higher than in 2006.

Operating expenses declined by 5 per cent, mainly as a result of reduced performance-related remuneration resulting from lower revenues. Expenses were also reduced by savings initiatives started in late 2006 and early 2007 though these were offset by the restructuring costs associated with the Group's exit from the mortgage-backed securities business.

**Private Banking** reported a pre-tax profit of US\$174 million. Excluding a US\$39 million geographical reclassification, the underlying increase was 27 per cent, reflecting improvements in Bermuda and the US, the addition of Private Banking in Canada and a one-off gain from the sale of Wealth and Tax Advisory Services (WTAS) to its management. The revenue growth was partially offset by increased costs from the launch of Private

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Banking in Canada. The cost efficiency ratio reflected this, remaining broadly flat at 69.3 per cent.

Net interest income increased by 14 per cent to US\$273 million, excluding a US\$42 million geographical reclassification. This was driven by new business in Canada and an increase in deposit volumes in Bermuda. Net interest income in the US remained broadly flat as a result of competitive pressures.

Growth in net fee income of 16 per cent to US\$279 million was driven by higher investment in discretionary funds especially the multi-manager products offered in the US. WTAS also contributed to the rise; this business was subsequently sold on 31 December 2007 in order to enable Private Banking to focus on core activities. The sale resulted in an US\$18 million gain in other operating income.

Client assets of US\$58 billion, an increase of 35 per cent, reflected expansion into Canada, a market-driven rise in assets and net new money of US\$933 million.

Loan impairment charges decreased by 71 per cent to US\$10 million, reflecting the non-recurrence of a large single loan impairment charge in 2006.

Operating expenses rose by 17 per cent to US\$415 million, with a rise in staff costs in both support and front-office positions and the launch of operations in Canada.

Within **Other**, profit before tax increased to US\$1.5 billion, driven largely by significant fair value movements on HSBC's own debt as a result of the widening of credit spreads and related derivatives in the second half of the year.

HSBC Technology USA Inc. and hsbc.com provide technology services across North America, the costs of which are recharged to specific entities. Increased activity during the period contributed to a 14 per cent rise in operating expenses which were recovered through [Other operating income].

Year ended 31 December 2006 compared with year ended 31 December 2005

### **Economic briefing**

In the **US**, GDP growth in 2006 was 2.9 per cent. Growth in the second half of the year moderated to below 3 per cent, after average annualised growth of 4.1 per cent in the first half of the year. Consumer spending in 2006 grew by 3.4 per cent, with average annualised growth of 3.6 per cent in the second half of the year. Housing activity weakened substantially in 2006, with annualised declines in residential investment of 11 per cent in the second quarter

followed by annualised declines of 19 per cent in the third and fourth quarters of the year. There was some optimism that housing starts may have begun to stabilise by the year-end, with housing permits rising in December after ten successive monthly falls. Continued strong profits growth meant that business investment remained robust but industrial production weakened markedly towards the end of the year. The unemployment rate remained relatively low, averaging 4.6 per cent in 2006. The trade deficit stabilised through most of the year and narrowed in the final months of 2006 in response to strong global growth and a weaker US dollar. Inflation rose by 4.3 per cent in the first half of the year due to energy price rises but subsequently fell to an annual rate of about 2 per cent as energy prices declined. The Federal Reserve raised short-term interest rates by 1 per cent in the first half of 2006 to 5.25 per cent, but kept rates unchanged thereafter. After rising from 4.4 per cent to 5.2 per cent in the first half of 2006, 10-year note yields fell to a low of 4.4 per cent in early December before increasing to 4.7 per cent by the year-end. The S&P500 stock market index rose by 13.6 per cent in the year.

The **Canadian** economy slowed during 2006, with GDP growth falling from an annualised rate of 3.6 per cent at the beginning of the year to 1.7 per cent by the third quarter, largely reflecting slower export growth. Domestic demand remained robust and HSBC expects the momentum seen in 2006 to continue through 2007, supported by historically low levels of unemployment and a housing market which, although showing signs of moderation, remained strong throughout 2006. Although energy prices eased, 2006's commodity boom was expected to continue benefiting the Canadian economy through 2007. Inflation remained problematic with core prices moving above the Bank of Canada's preferred target rate of 2 per cent, and productivity remained

relatively weak. Having raised its overnight interest rate from 3.25 per cent at the start of 2006 to 4.25 per cent in May, the Bank of Canada kept rates on hold for the rest of the year.

**Review of business performance**

HSBC's operations in North America reported a pre-tax profit of US\$4.7 billion compared with US\$5.9 billion in 2005, a decrease of 21 per cent. On an underlying basis, pre-tax profits declined by 25 per cent. Underlying net operating income before loan impairment charges was higher by 6 per cent, reflecting the income benefit of asset growth in Personal Financial Services . This revenue growth was more than offset by a significant rise in loan impairment charges in the correspondent mortgage

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services business within HSBC Finance, as slowing house price appreciation and the projected effect of interest rate resets impacted loss estimates from rising credit delinquency. This is described more fully below and on page 221. In Commercial Banking, investment in distribution channels delivered growth from increased lending and deposit taking. In Global Banking and Markets, strong trading results more than offset lower balance sheet

management revenues, which were constrained by compressed spreads in a flat interest rate yield curve environment. Underlying operating expenses increased by 13 per cent to support investment in business expansion and branch openings in the Personal Financial Services business.

The commentary that follows is on an underlying basis.

**Reconciliation of reported and underlying profit before tax**

Year ended 31 December 2006 compared with year ended 31 December 2005

	2005	Currency translation <sub>1</sub>	2005 at 2006 exchange rates	Acqui- sitions and disposals <sub>2</sub>	Underlying change	2006 as reported	Reported change	Underlying change
North America	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m	%	%
Net interest income	13,295	56	13,351	528	389	14,268	7	3
Net fee income	3,952	21	3,973	225	568	4,766	21	14
Other income <sup>3</sup>	2,294	9	2,303	13	277	2,593	13	12
Net operating income <sup>4</sup>	19,541	86	19,627	766	1,234	21,627	11	6
Loan impairment charges and other credit risk provisions	(4,916)	3	(4,913)	(291)	(1,592)	(6,796)	(38)	(32)
Net operating income	14,625	89	14,714	475	(358)	14,831	1	(2)

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Operating expenses	(8,758)	(43)	(8,801)	(291)	(1,101)	(10,193)	(16)	(13)
Operating profit	5,867	46	5,913	184	(1,459)	4,638	(21)	(25)
Income from associates	48	□	48	□	(18)	30	(38)	(38)
Profit before tax	5,915	46	5,961	184	(1,477)	4,668	(21)	(25)

For footnotes, see page 130.

**Personal Financial Services** generated a pre-tax profit of US\$3.4 billion, a decrease of 23 per cent compared with 2005. Net operating income rose at a slower rate than cost growth, due to constrained balance sheet growth in the second half of the year, higher collection expense and significantly higher loan impairment charges. The increased loan impairment charges recognised in respect of HSBC Finance's correspondent mortgage services business more than offset the non-recurrence of charges arising in respect of hurricane Katrina and the change in bankruptcy legislation in 2005. The cost efficiency ratio worsened as costs rose faster than revenues.

In the US, pre-tax profit of US\$3.1 billion was 24 per cent lower than in 2005, reflecting the significantly higher loan impairment charges noted above and additional costs incurred in support of business expansion in both the consumer finance company and the retail bank. Beginning in 2004, HSBC implemented a growth strategy for its core banking network in the US which included building deposits over a three to five year period across multiple markets and segments utilising diverse

delivery systems. During 2006 the strategy included various initiatives, the most important of these being growing the deposit base by emphasising more competitive pricing and introducing high yielding products, including internet savings accounts. These have grown significantly since late 2005 to US\$7 billion, of which US\$6 billion arose in 2006 and US\$5 billion of the 2006 growth was from new customers. Retail branch expansion in existing and new geographic markets was also a key initiative, with 25 new branches opened in 2006.

In Canada, profit before tax was 21 per cent lower, partly due to the absence of provision releases made in 2005 in the core banking operations. Revenues rose but this was offset by costs incurred in support of expansion in consumer finance and investments made in the bank distribution channels.

Net interest income of US\$13.0 billion was 7 per cent higher than in 2005. In the US, there was strong growth in mortgages, cards and other personal non-credit card lending, particularly in the first half of the year, and this, coupled with higher deposit balances, led to a 6 per cent increase in net interest

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income as competition reduced both asset and deposit spreads.

Average deposit balances in the US rose by 21 per cent to US\$32.2 billion, mainly led by the continued success of online savings. The HSBC Premier investor product also continued to grow strongly. During the year over 22,000 new accounts were opened and balances rose by 139 per cent as US\$2.1 billion in incremental deposits were taken. Customers migrated to higher yielding products which led to a change in product mix, and the consequent reduction in spreads partly offset the benefits of balance growth.

There was a marked slowdown in the US housing market during 2006, although towards the end of the year demand for housing showed signs of stabilising. However, the supply of houses for sale remained high, with the overall outlook still uncertain. Average mortgage balances rose by 9 per cent to US\$123.8 billion, with growth concentrated in non-prime balances in the mortgage services correspondent and branch-based consumer lending businesses. Prime mortgage balances originated and retained through the core banking network continued to decline. This reflected an ongoing strategic initiative to manage the balance sheet by selling the majority of new prime loan originations to government-sponsored enterprises and private investors, along with planned securitisations and the normal run-off of balances. Overall, yields improved from the combined effects of a change in product mix to higher-yielding non-prime mortgages and repricing initiatives. Despite this improvement in yields, spreads narrowed due to higher funding costs as interest rates rose, and this reduced the positive income benefit of the higher lending balances.

The following comments on mortgage lending relate to HSBC Finance as mortgage lending growth in 2006 was concentrated in this business.

In the branch-based consumer lending business, average mortgage balances grew by 15 per cent to US\$41.2 billion as lending secured on real estate, which included a near-prime product introduced in 2003, was pursued. This growth was augmented by portfolio acquisitions, most notably the US\$2.5 billion Champion mortgage portfolio purchased from KeyBank, NA in November 2006.

In the mortgage services correspondent business, average balances of US\$49.9 billion were 28 per cent higher than in 2005. During 2005 and the first half of 2006, emphasis was placed on increasing both first and second lien mortgages by expanding sources for the purchase of loans from correspondents. In the second quarter of 2006,

HSBC began to witness deterioration in the performance of mortgages acquired in 2005, particularly in the second lien and portions of the first lien portfolios. This deterioration continued in the third quarter and began to affect the equivalent loans acquired in 2006. In the final quarter of 2006, the deterioration worsened considerably, mainly in first lien ARM balances and second lien loans.

A series of actions were initiated in the third quarter to mitigate risk in the affected components of the portfolio. These included revising pricing in selected origination segments, tightening underwriting criteria to eliminate or substantially reduce higher risk products (especially in respect of second lien, stated income (low documentation) and lower credit scoring segments), and enhancing segmentation and analytics to identify higher risk portions of the portfolio and increase collections. These initiatives led to a decline in overall portfolio balances during the second half of 2006, mostly attributable to lower purchases of second lien and certain higher-risk products, along with the normal run-off of balances.

Average credit card balances in the US rose by 6 per cent to US\$26.8 billion. The market continued to be highly competitive with many lenders placing reliance on promotional rate offers to generate growth. HSBC took a strategic decision to reduce the amount of its equivalent offers and instead grew its HSBC branded prime, Union Privilege and non-prime portfolios largely from targeted marketing campaigns. Margins widened, reflecting improved yields as the product mix changed towards higher levels of non-prime and lower levels of promotional balances, coupled with other re-pricing initiatives undertaken on variable rate products. This more than offset the adverse effect of higher funding costs and augmented the income benefits of the increased loan book.

In the retail services business, average balances rose by 6 per cent to US\$15.8 billion. This was mainly driven by newer merchants, changes in product mix and the launch of three co-branded programmes; the MasterCard and Visa partnerships with Best Buy and Saks Fifth Avenue, and the Neiman Marcus co-branded card with American Express. The positive income benefits from higher balances were more than offset by lower spreads, as a large proportion of the loan book priced at fixed rates was affected by higher funding costs. This was further affected by changes in the product mix as lower yielding department store card balances grew more strongly, and by competitive downward pricing pressures. Changes in merchant contractual obligations also led to lower net interest income,



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though this was offset by reduced partnership payments to those merchants.

Growth opportunities in the motor vehicle financing industry were particularly challenging in 2006, driven by a reduction in incentive programmes offered by manufacturers and a rising interest rate environment. Notwithstanding these factors, average balances rose by 12 per cent. This was led by strong organic growth in the near-prime portfolio from an increased emphasis on strengthening relationships with active dealers, and greater volumes generated from the consumer direct programme. Refinancing volumes rose, directly attributable to the successful consumer refinance programme, which recorded a 48 per cent increase in originations.

In Canada, net interest income rose by 16 per cent due to lending and deposit growth. Average mortgage balances grew as a result of the continued strength of the housing market and ongoing branch expansion in the consumer finance business. The strong economy drove higher levels of unsecured lending as consumer spending rose. Expansion of the consumer finance motor vehicle proposition and the launch of a MasterCard programme in 2005 contributed further to asset growth, while increased marketing activity led to a rise in personal non-credit card lending balances. Asset spreads narrowed, largely from lower yields which reflected changes in product mix and competitive market conditions.

Average deposit balances grew by 6 per cent compared with 2005, with the notable success of a new high rate savings account and a sale campaign celebrating HSBC's 25th anniversary in Canada. Deposit spreads widened as interest rates rose, contributing further to the increase in net interest income.

Net fee income grew by 13 per cent to US\$3.7 billion, with increases in both the US and Canada. The 13 per cent rise in the US was largely led by higher fees from the credit card and retail services businesses. Credit card fee income from the consumer finance business increased by 8 per cent, primarily from balance growth in the non-prime portfolio, improved interchange rates and lower fee charge-offs. Revenues from credit card partnership enhancement services rose due to greater sales volumes, expansion into new customer segments and balance growth.

Within the US retail services business, net fee income rose, reflecting lower merchant payments, in part due to changes in contract obligations with certain merchants. A rise in late fees from growth in customer account balances and higher fees on

overdue payments contributed further to the increase.

In the US mortgage-banking business, net fee income declined. Although mortgage loan service volumes grew in 2006, contributing additional fee income from the greater proportion of mortgages originated and then sold with mortgage servicing rights (MSRs) retained, these benefits were more than offset by higher amortisation charges and lower releases of temporary impairment provisions on MSRs. The taxpayer financial services business generated higher fee income from increased loan volumes during the 2006 tax season.

In Canada, net fee income rose by 5 per cent to US\$217 million. Continued growth in the wealth management business resulted in higher investment administration fees, and credit card fee income rose, driven by increased lending.

Trading income fell by 17 per cent, due to lower income on HSBC Finance's Decision One mortgage balances held for resale to secondary market purchasers. This primarily reflected additional losses incurred following the repurchase of certain mortgages previously sold to external third parties which had subsequently gone into default. Higher losses on derivatives that did not meet the criteria for hedge accounting contributed further to the decrease.

A US\$20 million gain from the MasterCard Incorporated IPO was the key reason for the increase in gains from financial instruments.

Other operating income also rose, primarily driven by gains on various asset disposals. Most notably, a US\$123 million profit was achieved on disposal of HSBC's investment in Kanbay International Inc, a worldwide information technology services firm. Income from overnight and short-term money market investments also rose. These benefits were partly offset by greater losses incurred on sales of repossessed properties, following a 42 per cent rise in such properties as customers defaulted on their mortgage payments.

Loan impairment charges and other credit risk provisions of US\$6.7 billion were 28 per cent higher than in 2005. In the US, loan impairment charges rose by 28 per cent despite the non-recurrence of significant charges which arose in 2005 following hurricane Katrina and increased levels of bankruptcy filings in the final quarter of the year. Loan impairment charges were also higher in the second half of 2006 compared with both the preceding half and the second half of 2005. The increase was primarily driven by significantly higher delinquencies and losses in the mortgage services

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correspondent business, concentrated in second lien and portions of first lien mortgages originated and purchased in 2005 and 2006. As noted previously, HSBC witnessed a deterioration in the performance of these 2005 originations during the first half of 2006. This deterioration continued into the third quarter and started to affect equivalent loans originated in 2006. In the final quarter of 2006, deterioration of these loans, largely the first lien adjustable-rate and second lien loans, worsened considerably. The heightened risk of loss was attributable to lower equity in homes as price growth moderated or reversed, together with a higher prospective interest burden from ARM resets. As many of these mortgages were being re-priced in an environment of higher interest rates, slower asset price appreciation and tightening credit, HSBC considers it highly likely that these factors will lead to increased instances of default in the future on both first and any associated second lien loans. Accordingly, a significant increase in loan impairment charges was recorded in the final quarter of the year.

Higher lending, the seasoning of the loan portfolio, and a return to more normal historical levels of delinquency from the exceptionally favourable credit conditions experienced in recent periods, all contributed to the overall increase in impairment charges in the US. This was partly offset by lower numbers and levels of bankruptcy filings and the positive effect of low unemployment. The credit card business, in addition, benefited from improved recovery rates from loans previously written off. Notwithstanding the accelerated credit weakness witnessed in the mortgage services correspondent business, credit performance as measured by delinquency and loss in the majority of the other lending portfolios, including mortgage balances originated through the branch-based consumer lending business gradually deteriorated from the seasoning of a growing portfolio and the rising proportion of credit card balances. Loan impairment charges in these portfolios were consequently higher in the second half of 2006 as these portfolios seasoned, coinciding with the weakening housing market.

In Canada, loan impairment charges were 38 per cent higher. This primarily reflected the non-recurrence of loan impairment releases from core banking operations, which occurred in 2005, as well as growth in both secured and unsecured lending balances and higher delinquency rates in the motor vehicle finance business.

Operating expenses grew by 12 per cent to US\$7.4 billion. In the US, costs of US\$6.7 billion

were 11 per cent higher than in 2005. In the consumer finance business, the rise was driven by increased headcount to support incremental collections activity, and greater volumes. Higher costs were incurred in marketing cards to support the launch of new co-branded credit cards, greater levels of mailing and other promotional campaigns in the cards and retail services businesses. IT and administrative expenses grew in support of higher asset balances. A lower level of deferred origination costs in the mortgage services business, due to a decline in volumes, contributed further to the cost growth.

In HSBC Bank USA, expense growth was primarily driven by branch staff costs from additional headcount recruited to support investment in business expansion and new branch openings. Greater emphasis placed on increasing the quality and number of branch staff dedicated to sales and customer relationship activities, which changed the staff mix, also contributed to cost growth. The continued promotion of the online savings product, new branch openings and branding initiatives at the John F. Kennedy International and LaGuardia airports in New York led to a rise in marketing costs. IT costs also grew following significant investment expenditure incurred on several key network efficiency projects.

In Canada, costs rose by 19 per cent, mainly due to higher staff and marketing costs. Staff costs grew by 13 per cent, with increased headcount supporting expansion of the consumer finance business and bank distribution network. Continuing investment in growing the wealth management business and higher incentive costs reflecting improved revenues also contributed to the increase. Marketing costs grew following external campaigns to improve brand awareness.

**Commercial Banking** pre-tax profits rose by 4 per cent to US\$957 million, largely driven by lending and deposit growth and higher fee income, partly offset by increased loan impairment charges. Costs rose mainly from geographical expansion in the US and branch and business expansion in Canada. The cost efficiency ratio worsened by 2.1 percentage points, as costs grew faster than revenues.

Net interest income grew by 15 per cent to US\$1.4 billion. In the US, net interest income was 13 per cent higher, as HSBC continued to expand its geographical presence, notably in Boston, Connecticut, New Jersey, Philadelphia, Washington D.C., Chicago and Los Angeles. Average deposit balances rose by 30 per cent, aided by geographical



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expansion and greater focus placed on generating balances from commercial real estate companies and middle market customers. In particular, there was an increased emphasis on attracting high margin balances from cash management sales activities. Rising interest rates encouraged customers to transfer funds to higher yielding products and the resulting change in product mix led to a narrowing of liability spreads.

The 7 per cent growth in average lending balances was principally led by greater volumes generated from small business and middle market customers. This was achieved by a combination of geographical expansion, increased marketing activity and the recruitment of additional small-business relationship managers. Asset spreads narrowed due to competitive pricing pressures, particularly in the middle market customer segment, which partly offset the income benefits from higher lending volumes.

In Canada, net interest income increased by 14 per cent. The strong economy encouraged continued business investment by customers and this, in conjunction with HSBC's reputation for customer service and relationship management, helped generate a 15 per cent growth in average lending balances. Loan spreads were broadly in line with 2005. There was a 35 per cent improvement in average deposit balances, driven by various factors including the acquisition of new customers, strengthening relationships with existing ones, and enhancing payment and cash management products. Deposit spreads widened as interest rates rose, augmenting the income benefits from higher balances.

Net interest income in Bermuda grew by 42 per cent, partly due to interest rate rises which widened deposit spreads. Deposit balances increased by 26 per cent, while increased cross-sales activity contributed to a 26 per cent rise in average lending balances.

Net fee income improved by 13 per cent to US\$329 million. In the US, the 11 per cent rise was primarily due to an increase in syndication capabilities, which led to higher commercial mortgage fees, and from business expansion into new geographical markets. In Canada, growth in new lending business led to higher levels of service charges, and credit fees increased following the rise in customer numbers. Product enhancements and additions to the sales force helped grow fee income from payment and cash management services.

There was a small reduction in other operating income, largely due to the net effects of lower gains on asset disposals in the US.

Also in the US, the redemption of bonds issued by the Venezuelan government led to a US\$19 million gain from financial instruments.

Loan impairment charges were US\$74 million compared with a net release of US\$21 million in 2005. In the US, the increase reflected strong growth in lending balances to small and middle market customers, higher write-offs in the small business segment and the exceptionally low charges recorded in 2005 compared with historical levels. Loan impairment charges rose in Canada following the non-recurrence of releases which occurred in 2005 and, in Bermuda, net releases compared with charges in 2005.

Operating expenses grew by 21 per cent to US\$814 million. The 27 per cent rise in the US was driven by a combination of increased costs incurred in support of geographical expansion and the recruitment of additional sales staff to drive revenue growth. In Canada, operating expenses were 14 per cent higher from additional headcount recruited to support branch and network expansion and increased salary and bonus costs, which

reflected improved revenues. Expenditure incurred in order to develop the business, largely due to HSBC brand campaigns, contributed further to cost growth.

Income from associates rose by US\$34 million, including HSBC's share from an equity investment in Wells Fargo HSBC Trade Bank N.A. of US\$11 million in the US. Income from associates of US\$22 million in Canada was attributable to higher gains and distributions from private equity fund investments. These funds, in which HSBC has maintained a minority interest, were established to provide institutional investors with access to private equity investment opportunities.

**Global Banking and Markets** reported a pre-tax profit of US\$423 million, 28 per cent lower than in 2005. The result in 2005 benefited from a US\$106 million favourable movement on ineffective hedges on HSBC's own debt and, excluding this, profit before tax decreased by 12 per cent. The fall in profits was primarily due to a decline in balance sheet management revenues. Balance sheet management activity continued to be constrained by compressed spreads in a flat interest rate yield curve environment, with a resultant decrease of US\$347 million. Operating expenses were higher by 19 per cent with a significant portion of the increase driven by the first full year effect of recruitment and business expansion in 2005, and by specific

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initiatives taken in early 2006. This investment in extending the trading platform, notably in mortgage-backed securities, structured derivatives, metals and foreign exchange, produced record trading revenues.

Net fee income and trading income also grew, reflecting the measures taken to strengthen HSBC's presence in the region.

In Global Banking, net interest income in payments and cash management rose by 66 per cent, largely due to an over 50 per cent growth in balances.

Net fee income rose by 13 per cent to US\$656 million. Increases in fee income within the newly expanded mortgage-backed securities and equity underwriting businesses were driven by higher volumes. The securities services business benefited from a combination of new client volumes and market-driven asset growth. However, income from debt underwriting activity declined due to fewer deals, particularly in the second half of the year. In Global Banking, higher transaction volumes in the recently enhanced payments and cash management business, and an increase in customer volumes driven by a wider product offering, led to higher net fee income.

HSBC's operation in Canada reported a 31 per cent increase in fees, reflecting a growth in funds under management within HSBC Global Asset Management, coupled with higher fees from the lending business and securities services.

Net trading income more than doubled to US\$818 million. In Global Markets, a wider product offering and improved sales capabilities drove significant gains across all major client-related activities. Revenues were further boosted by the first full year contribution from the mortgage-backed securities trading business. Credit and Rates benefited from tightening credit spreads and increased customer flows. Structured derivatives income more than doubled, reflecting successful product launches as well as increased sales of tailored solutions. Revenues in the foreign exchange business remained robust against the backdrop of a weakening US dollar.

In Canada, trading income more than doubled, with higher gains from foreign exchange; a result of increased volatility of the Canadian dollar against the US dollar.

Gains from financial investments were 79 per cent lower as income from the disposal of securities declined.

A 50 per cent increase in other income was driven in part by higher revenues in HSBC's Sharia-compliant property fund business, which were offset by higher related costs.

The overall credit environment remained stable, although a small loan impairment charge of US\$3 million compared unfavourably to a net release of US\$64 million in 2005.

Operating expenses increased by 19 per cent to US\$1,641 million, mainly due to the first full year effect of the business expansion which took place in 2005 and additional expenditure in early 2006. In Global Markets, cost growth was primarily driven by the mortgage-backed securities, structured derivatives and equity businesses. Staff costs increased by 11 per cent, reflecting the first full year effect of people recruited in 2005, performance incentives that rose in line with revenue and selective hires in early 2006.

Operational expenses in the payments and cash management and the securities services businesses increased as business volumes grew and the related support businesses were expanded.

HSBC's share of profits from associates declined significantly reflecting the non-recurrence of distributions from a private equity associate.

**Private Banking** contributed a pre-tax profit of US\$114 million, an increase of 12 per cent compared with 2005. HSBC's onshore presence was enhanced by the opening of offices in Chicago and Greenwich, Connecticut. Revenue growth, driven by significantly higher core fees and commissions and improved trading results, was offset in part by loan impairment charges of US\$35 million, US\$29 million of which related to a single customer.

The cost efficiency ratio improved by 6.2 percentage points to 70.4 per cent.

Net interest income increased by 15 per cent to US\$212 million. A deposit-raising campaign proved successful at garnering funds, the total raised by the year-end reaching US\$2.5 billion. Overall, deposit balances rose by 25 per cent and lending balances increased by 14 per cent. Deposit spreads were marginally lower than in 2005.

Net fee income grew strongly, increasing by 20 per cent to US\$240 million. WTAS continued to expand its client base – it rose by 31 per cent in 2006 – and reported significant revenue growth, benefiting from restrictions placed on the major auditing firms with regard to providing personal tax advice to employees of audit clients. Higher funds under management and an increase in referrals with other



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*North America > 2006 / Profit/(loss) before tax by customer group*

HSBC businesses also contributed to the increased level of fee income.

A one-off gain of US\$9 million arose from a partial disposal of a holding in the Hermitage Fund, offsetting the non-recurrence of US\$9 million of income following the sale of a number of small trust businesses in 2005.

Client assets increased by 5 per cent to US\$43 billion, with net new money of US\$5 billion. This included a significant contribution from the higher fee-earning discretionary SIS and CIS products in which the value of client assets rose to US\$1.4 billion.

Operating expenses of US\$355 million were 10 per cent higher than in 2005. This rise was primarily attributable to hiring front office Private Banking staff and fee-earning staff within WTAS.

In **Other**, movements in the fair value of own debt and associated swaps resulted in losses of US\$128 million in 2006, compared with profits of US\$401 million in 2005.

Business expansion led to higher transaction volumes, which resulted in increased utilisation of IT systems and solutions. Branch expansion, the integration of Metris, and the launch of new products also contributed to an 8 per cent increase in costs and income at the group's North American technology centre. In *hsbc.com*, accrued costs associated with the development of HSBC's second generation internet banking platforms were recharged to other customer groups, which resulted in higher operating income.

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Profit/(loss) before tax and balance sheet data by customer group and global business

## Year ended 31 December 2007

	<b>Personal Financial Services US\$m</b>	<b>Commercial Banking US\$m</b>	<b>Global Banking &amp; Markets US\$m</b>	<b>Private Banking US\$m</b>	<b>Other US\$m</b>	<b>Inter- segment elimination<sup>14</sup> US\$m</b>	<b>Total US\$m</b>
Net interest income/(expense)	13,175	1,558	378	273	(17)	(520)	14,847
Net fee income/(expense)	4,571	338	701	279	(79)	□	5,810
Trading income/(expense) excluding net interest income	(349)	(2)	(871)	11	(78)	□	(1,289)
Net interest income/(expense) on trading activities	134	□	137	□	(44)	520	747
Net trading income/(expense) <sup>5</sup>	(215)	(2)	(734)	11	(122)	520	(542)
Net income from financial instruments designated at fair value	□	□	11	□	1,739	□	1,750
Gains less losses from financial investments	176	(1)	65	2	3	□	245
Dividend income	47	1	57	□	□	□	105
Net earned insurance premiums	449	□	□	□	□	□	449
Other operating income/(expense)	(5)	88	167	34	1,480	(1,404)	360
<b>Total operating income</b>	<b>18,198</b>	<b>1,982</b>	<b>645</b>	<b>599</b>	<b>3,004</b>	<b>(1,404)</b>	<b>23,024</b>
Net insurance claims <sup>6</sup>	(241)	□	□	□	□	□	(241)
<b>Net operating income<sup>4</sup></b>	<b>17,957</b>	<b>1,982</b>	<b>645</b>	<b>599</b>	<b>3,004</b>	<b>(1,404)</b>	<b>22,783</b>
Loan impairment charges and other credit risk provisions	(11,909)	(191)	(46)	(10)	□	□	(12,156)
<b>Net operating income</b>	<b>6,048</b>	<b>1,791</b>	<b>599</b>	<b>589</b>	<b>3,004</b>	<b>(1,404)</b>	<b>10,627</b>

Total operating expenses	<u>(7,594)</u>	<u>(893)</u>	<u>(1,562)</u>	<u>(415)</u>	<u>(1,496)</u>	<u>1,404</u>	<u>(10,556)</u>
<b>Operating profit/(loss)</b>	<b>(1,546)</b>	<b>898</b>	<b>(963)</b>	<b>174</b>	<b>1,508</b>	□	<b>71</b>
Share of profit/(loss) in associates and joint ventures	□	<b>22</b>	<b>(2)</b>	□	□	□	<b>20</b>
<b>Profit/(loss) before tax</b>	<b>(1,546)</b>	<b>920</b>	<b>(965)</b>	<b>174</b>	<b>1,508</b>	□	<b>91</b>
	%	%	%	%	%		%
Share of HSBC's profit before tax	<b>(6.4)</b>	<b>3.8</b>	<b>(4.0)</b>	<b>0.7</b>	<b>6.3</b>		<b>0.4</b>
Cost efficiency ratio	<b>42.3</b>	<b>45.1</b>	<b>242.2</b>	<b>69.3</b>	<b>49.8</b>		<b>46.3</b>
	<b>US\$m</b>	<b>US\$m</b>	<b>US\$m</b>	<b>US\$m</b>	<b>US\$m</b>		<b>US\$m</b>
<b>Balance sheet data<sup>7</sup></b>							
Loans and advances to customers (net)	<b>218,676</b>	<b>38,930</b>	<b>26,186</b>	<b>6,068</b>	□		<b>289,860</b>
Total assets	<b>240,734</b>	<b>43,920</b>	<b>217,808</b>	<b>6,541</b>	<b>1,089</b>		<b>510,092</b>
Customer accounts	<b>61,824</b>	<b>36,306</b>	<b>30,732</b>	<b>16,187</b>	<b>124</b>		<b>145,173</b>
The following assets and liabilities were significant to Global Banking and Markets:							
loans and advances to banks (net)			<b>14,938</b>				
trading assets, financial instruments designated at fair value, and financial investments <sup>16</sup>			<b>126,669</b>				
deposits by banks			<b>14,825</b>				

For footnotes, see page 130.

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*North America > Profit/loss before tax by customer group*Profit/(loss) before tax and balance sheet data by customer group and global business (*continued*)

Year ended 31 December 2006

North America	Personal	Commercial	Global	Private	Other	Inter-	Total
	Financial Services US\$m	Banking US\$m	Banking & Markets US\$m	Banking US\$m	US\$m	segment elimination <sup>14</sup> US\$m	
Net interest income/(expense)	12,964	1,362	266	212	(52)	(484)	14,268
Net fee income/(expense)	3,675	329	656	240	(134)	□	4,766
Trading income/(expense) excluding net interest income	66	13	746	12	(220)	□	617
Net interest income/(expense) on trading activities	208	□	72	□	(23)	484	741
Net trading income/(expense) <sup>5</sup>	274	13	818	12	(243)	484	1,358
Net expense from financial instruments designated at fair value	□	□	(11)	□	(52)	□	(63)
Gains less losses from financial investments	14	19	12	9	4	□	58
Dividend income	23	1	61	□	□	□	85
Net earned insurance premiums.	492	□	□	□	□	□	492
Other operating income	270	87	269	31	1,536	(1,271)	922
<b>Total operating income</b>	<b>17,712</b>	<b>1,811</b>	<b>2,071</b>	<b>504</b>	<b>1,059</b>	<b>(1,271)</b>	<b>21,886</b>
Net insurance claims <sup>6</sup>	(259)	□	□	□	□	□	(259)
<b>Net operating income<sup>4</sup></b>	<b>17,453</b>	<b>1,811</b>	<b>2,071</b>	<b>504</b>	<b>1,059</b>	<b>(1,271)</b>	<b>21,627</b>
Loan impairment charges and other credit risk provisions	(6,683)	(74)	(3)	(35)	(1)	□	(6,796)
<b>Net operating income</b>	<b>10,770</b>	<b>1,737</b>	<b>2,068</b>	<b>469</b>	<b>1,058</b>	<b>(1,271)</b>	<b>14,831</b>

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Total operating expenses	(7,379)	(814)	(1,641)	(355)	(1,275)	1,271	(10,193)
Operating profit/(loss)	3,391	923	427	114	(217)	□	4,638
Share of profit/(loss) in associates and joint ventures	□	34	(4)	□	□	□	30
Profit/(loss) before tax	3,391	957	423	114	(217)	□	4,668

%                      %                      %                      %                      %                      %

Share of HSBC's profit before tax	15.4	4.3	1.9	0.5	(1.0)		21.1
Cost efficiency ratio	42.3	44.9	79.2	70.4	120.4		47.1

US\$m                      US\$m                      US\$m                      US\$m                      US\$m                      US\$m

Balance sheet data <sup>7</sup>							
Loans and advances to customers (net)	220,517	34,651	17,215	5,604	□		277,987
Total assets	250,985	43,012	208,958	6,558	1,677		511,190
Customer accounts	54,099	31,066	23,711	11,938	108		120,922

The following assets and liabilities were significant to Global Banking and Markets:

□ loans and advances to banks (net)			15,862				
□ trading assets, financial instruments designated at fair value, and financial investments <sup>16</sup>			136,141				
□ deposits by banks			9,664				

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Year ended 31 December 2005

	Personal Financial Services US\$m	Commercial Banking US\$m	Global Banking & Markets US\$m	Private Banking US\$m	Other US\$m	Inter- segment elimination <sup>14</sup> US\$m	Total US\$m
<b>North America</b>							
Net interest income/(expense)	11,636	1,157	661	185	(114)	(230)	13,295
Net fee income/(expense)	3,050	283	577	200	(158)	□	3,952
Trading income excluding net interest income	119	7	95	7	22	□	250
Net interest income/(expense) on trading activities	210	(4)	221	(1)	(21)	230	635
Net trading income <sup>5</sup>	329	3	316	6	1	230	885
Net income/(expense) from financial instruments designated at fair value	10	□	23	(1)	402	□	434
Gains less losses from financial investments	(12)	1	57	□	1	□	47
Dividend income	8	□	33	□	□	□	41
Net earned insurance premiums	478	□	□	□	(1)	□	477
Other operating income	232	87	179	34	1,280	(1,170)	642
<b>Total operating income</b>	<b>15,731</b>	<b>1,531</b>	<b>1,846</b>	<b>424</b>	<b>1,411</b>	<b>(1,170)</b>	<b>19,773</b>
Net insurance claims <sup>6</sup>	(232)	□	□	□	□	□	(232)
<b>Net operating income<sup>4</sup></b>	<b>15,499</b>	<b>1,531</b>	<b>1,846</b>	<b>424</b>	<b>1,411</b>	<b>(1,170)</b>	<b>19,541</b>
Loan impairment (charges)/ recoveries and other credit risk provisions	(5,001)	21	64	4	(4)	□	(4,916)
<b>Net operating income</b>	<b>10,498</b>	<b>1,552</b>	<b>1,910</b>	<b>428</b>	<b>1,407</b>	<b>(1,170)</b>	<b>14,625</b>
<b>Total operating expenses</b>	<b>(6,317)</b>	<b>(660)</b>	<b>(1,376)</b>	<b>(324)</b>	<b>(1,251)</b>	<b>1,170</b>	<b>(8,758)</b>
<b>Operating profit</b>	<b>4,181</b>	<b>892</b>	<b>534</b>	<b>104</b>	<b>156</b>	<b>□</b>	<b>5,867</b>
Share of profit in associates and joint ventures	□	□	39	□	9	□	48
<b>Profit before tax</b>	<b>4,181</b>	<b>892</b>	<b>573</b>	<b>104</b>	<b>165</b>	<b>□</b>	<b>5,915</b>
	%	%	%	%	%		%

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Share of HSBC's profit before tax	19.9	4.3	2.7	0.5	0.8	28.2
Cost efficiency ratio	40.8	43.1	74.5	76.4	88.7	44.8
	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m
Balance sheet data <sup>7</sup>						
Loans and advances to customers (net)	207,598	29,666	10,381	4,915	□	252,560
Total assets	240,474	36,570	149,623	5,823	□	432,490
Customer accounts	44,769	25,585	31,442	9,589	1	111,386
The following assets and liabilities were significant to Global Banking and Markets:						
□ loans and advances to banks (net)			9,979			
□ trading assets, financial fair value, and financial investments <sup>16</sup>			102,732			
□ deposits by banks			7,506			

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*Latin America > Profit/(loss) before tax***Latin America**

Profit/(loss) before tax by country within customer groups and global businesses

	<b>Personal</b>		<b>Global</b>			
	<b>Financial</b>	<b>Commercial</b>	<b>Banking</b>	<b>Private</b>	<b>Other</b>	<b>Total</b>
	<b>Services</b>	<b>Banking</b>	<b>&amp;</b>	<b>Banking</b>		
	<b>US\$m</b>	<b>US\$m</b>	<b>Markets</b>	<b>US\$m</b>	<b>US\$m</b>	<b>US\$m</b>
<b>Year ended 31 December 2007</b>						
Mexico	514	333	113	11	9	980
Brazil	293	286	297	9	(6)	879
Argentina	36	75	90	□	□	201
Panama	45	18	16	7	□	86
Other	5	28	1	(2)	□	32
	<b>893</b>	<b>740</b>	<b>517</b>	<b>25</b>	<b>3</b>	<b>2,178</b>
<b>Year ended 31 December 2006</b>						
Mexico	628	197	177	7	□	1,009
Brazil	121	185	218	6	(4)	526
Argentina	35	51	68	□	3	157
Panama	16	13	10	□	□	39
Other	□	5	2	1	(4)	4
	<b>800</b>	<b>451</b>	<b>475</b>	<b>14</b>	<b>(5)</b>	<b>1,735</b>
<b>Year ended 31 December 2005</b>						
Mexico	570	161	192	□	□	923
Brazil	167	147	95	1	(4)	406
Argentina	37	35	56	□	116	244
Panama	10	11	9	□	□	30
Other	2	3	(5)	□	1	1
	<b>786</b>	<b>357</b>	<b>347</b>	<b>1</b>	<b>113</b>	<b>1,604</b>

Loans and advances to customers (net) by country

At 31 December

<b>2007</b>	2006	2005
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	<b>US\$m</b>	US\$m	US\$m
Mexico	<b>18,059</b>	14,294	11,242
Brazil	<b>18,491</b>	11,469	7,975
Argentina	<b>2,485</b>	1,912	1,077
Panama	<b>4,158</b>	4,178	1,135
Other	<b>4,730</b>	3,938	252
	<b>47,923</b>	35,791	21,681

Customer accounts by country

	At 31 December		
	<b>2007</b>	2006	2005
	<b>US\$m</b>	US\$m	US\$m
Mexico	<b>22,307</b>	19,775	13,226
Brazil	<b>26,231</b>	19,946	14,847
Argentina	<b>2,779</b>	2,470	1,239
Panama	<b>5,062</b>	5,031	1,217
Other	<b>4,913</b>	3,639	460
	<b>61,292</b>	50,861	30,989

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## Profit before tax

	Year ended 31 December		
	2007 US\$m	2006 US\$m	2005 US\$m
<b>Latin America</b>			
Net interest income	5,576	4,197	3,342
Net fee income	2,153	1,630	1,191
Net trading income	548	537	537
Net income from financial instruments designated at fair value	320	237	186
Gains less losses from financial investments	253	84	80
Gains arising from dilution of interests in associates	11	□	□
Dividend income	9	6	5
Net earned insurance premiums	1,594	1,076	871
Other operating income	228	91	286
<b>Total operating income</b>	<b>10,692</b>	<b>7,858</b>	<b>6,498</b>
Net insurance claims incurred and movement in liabilities to policyholders .	(1,427)	(1,023)	(792)
<b>Net operating income before loan impairment charges and other credit risk provisions</b>	<b>9,265</b>	<b>6,835</b>	<b>5,706</b>
Loan impairment charges and other credit risk provisions	(1,697)	(938)	(676)
<b>Net operating income</b>	<b>7,568</b>	<b>5,897</b>	<b>5,030</b>
Total operating expenses	(5,402)	(4,166)	(3,426)
<b>Operating profit</b>	<b>2,166</b>	<b>1,731</b>	<b>1,604</b>
Share of profit in associates and joint ventures	12	4	□
<b>Profit before tax</b>	<b>2,178</b>	<b>1,735</b>	<b>1,604</b>
	%	%	%
Share of HSBC's profit before tax	9.0	7.9	7.7
Cost efficiency ratio	58.3	61.0	60.0
Year-end staff numbers (full-time equivalent)	64,404	64,900	55,600

Balance sheet data<sup>7</sup>

	At 31 December		
	2007 US\$m	2006 US\$m	2005 US\$m
Loans and advances to customers (net)	47,923	35,791	21,681
Loans and advances to banks (net)	12,675	12,634	8,964
Trading assets, financial instruments designated at fair value, and financial investments	24,715	20,497	16,945
Total assets	99,056	80,771	55,387
Deposits by banks	4,092	5,267	2,598
Customer accounts	61,292	50,861	30,989

For footnote, see page 130.

Year ended 31 December 2007 compared with year ended 31 December 2006

**Economic briefing**

In response to fluctuations in export demand from the US, economic growth in **Mexico** moderated during the course of 2007, with GDP rising an estimated 3.1 per cent during the year, compared with 4.8 per cent in 2006. Inflationary pressures remained significant throughout 2007, with consumer price inflation averaging 4 per cent, driven by increases in international prices of commodities, which affected domestic food prices in the core index. As a result, the Bank of Mexico raised its

overnight interest rate by a total of 50 basis points, and has maintained its restrictive monetary policy despite reductions in interest rates by the US Federal Reserve.

The **Brazilian** economy expanded strongly in 2007, with GDP expected to have grown by 5.4 per cent compared with 3.7 per cent in 2006. As in 2006, growth was driven by domestic demand, with private consumption rising considerably. As a consequence, the average unemployment rate fell to 9.3 per cent in 2007 from 10 per cent in 2006. After declining to 3.1 per cent at the end of 2006, the annual rate of consumer price inflation climbed to 4.5 per cent by

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**Latin America > 2007**

December 2007, mainly from higher food prices. The cycle of monetary easing which began in the third quarter of 2005 paused in October 2007 with the overnight rate at 11.25 per cent, the lowest level in several decades. After nine years of steady expansion, the trade balance surplus fell slightly in 2007, and is expected to decrease further in 2008. Balance of payments fundamentals, however, remained robust and, as a result, the Brazilian economy seemed less vulnerable to external shocks than in previous years.

The **Argentine** economy also performed strongly in 2007, with GDP expected to have risen by 8.7 per cent. This strength was a consequence of several factors such as a competitive exchange rate, spare capacity in the economy and a generally favourable external environment, which helped Argentina extend its fiscal and external surpluses into a fourth successive year. Less encouraging was the fact that inflation accelerated to about 13 per cent, up from 10 per cent in 2006. Although food inflation was part of the explanation, rapid demand growth was also a factor. 2007 was an election year, and as a result the rate of growth of fiscal spending

doubled to 45 per cent on an annual basis. As a consequence, the primary surplus fell by around 1.2 per cent of GDP.

Throughout the region as a whole, GDP growth roughly matched that of 2006. The slowdown in Mexico provided a contrast to better performances elsewhere in Central and Southern America. Central America grew by an estimated 6.3 per cent, up from 5.9 per cent in 2006 while, in South America, growth was an estimated 5.8 per cent, up from 5.3 per cent in 2006. The most dynamic economies in Central America were Panama (10.0 per cent growth in GDP) and the Dominican Republic (8.0 per cent), followed by Costa Rica (6.2 per cent) and Honduras (6.2 per cent). In South America, the fastest growing countries after Argentina were Peru (7.2 per cent growth in GDP), Venezuela (7.0 per cent) and Colombia (6.5 per cent). In general, inflation appears to be under control in Latin America, averaging around 5 per cent over the past three years. Only Venezuela and Argentina have experienced double-digit inflation, while the US dollar-based economies of Panama, Ecuador and El Salvador have better inflationary records.

**Reconciliation of reported and underlying profit before tax****Year ended 31 December 2007 compared with year ended 31 December 2006**

	2006 as reported	Currency translation <sup>1</sup>	2006 at 2007 exchange rates	Acquisitions, disposals and dilution gains <sup>2</sup>	Underlying change	2007 as reported	Reported change	Underlying change
Latin America	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m	%	%
Net interest income	4,197	261	4,458	375	743	5,576	33	17
Net fee income	1,630	86	1,716	86	351	2,153	32	20
Other income <sup>3</sup>	1,008	60	1,068	102	366	1,536	52	34

<b>Net operating income<sup>4</sup></b>	<b>6,835</b>	<b>407</b>	<b>7,242</b>	<b>563</b>	<b>1,460</b>	<b>9,265</b>	<b>36</b>	<b>20</b>
Loan impairment charges and other credit risk provisions	<b>(938)</b>	<b>(81)</b>	<b>(1,019)</b>	<b>(133)</b>	<b>(545)</b>	<b>(1,697)</b>	<b>(81)</b>	<b>(53)</b>
<b>Net operating income</b>	<b>5,897</b>	<b>326</b>	<b>6,223</b>	<b>430</b>	<b>915</b>	<b>7,568</b>	<b>28</b>	<b>15</b>
Operating expenses	<b>(4,166)</b>	<b>(258)</b>	<b>(4,424)</b>	<b>(320)</b>	<b>(658)</b>	<b>(5,402)</b>	<b>(30)</b>	<b>(15)</b>
<b>Operating profit</b>	<b>1,731</b>	<b>68</b>	<b>1,799</b>	<b>110</b>	<b>257</b>	<b>2,166</b>	<b>25</b>	<b>14</b>
Income from associates	<b>4</b>	<b>□</b>	<b>4</b>	<b>9</b>	<b>(1)</b>	<b>12</b>	<b>200</b>	<b>(25)</b>
<b>Profit before tax</b>	<b>1,735</b>	<b>68</b>	<b>1,803</b>	<b>119</b>	<b>256</b>	<b>2,178</b>	<b>26</b>	<b>14</b>

For footnotes, see page 130.

### Review of business performance

HSBC's operations in Latin America reported a pre-tax profit of US\$2.2 billion compared with US\$1.7 billion in 2006, representing an increase of 26 per cent. HSBC's acquisitions of HSBC Bank Panama and Banca Nazionale in 2006 strengthened the existing business platform and geographical representation, and 2007 has been a year of

integrating these operations into HSBC. On an underlying basis, pre-tax profits rose by 14 per cent as increased revenues were partly offset by higher loan impairment charges, largely from Mexico, and increased operating costs across the region.

Both Mexico and Brazil made notable contributions to Commercial Banking's pre-tax profits, which were 64 per cent higher than in 2006,

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Brazil from SMEs, Mexico from larger corporates. In Personal Financial Services, profit before tax increased by 12 per cent as strong growth in revenues was partly offset by increased loan impairment charges in Mexico. Profit before tax in Global Banking and Markets increased as strong growth in net fee and net interest income was partly offset by a decrease in trading income and higher costs related to business expansion.

Notwithstanding continuing investment and integration costs throughout the region, the cost efficiency ratio improved by 2.7 percentage points to 58.3 per cent.

The following commentary is on an underlying basis.

**Personal Financial Services** reported pre-tax profits of US\$893 million, 3 per cent higher than in 2006, as strong growth in revenues across the region was partly offset by increased loan impairment charges arising from the seasoning of recent organic business expansion, mainly in Mexico. Revenue rose by 21 per cent, driven by higher credit card balances in Mexico and an increased volume of personal and vehicle finance loans in Brazil. Four additional months of Banca Nazionale revenues in Argentina, a one-off adjustment to insurance embedded value in Mexico and gains from sales of financial investments in Brazil, also helped boost income. Loan impairment charges in Mexico rose significantly, driven by the growth in the past two years of the credit card portfolio and higher delinquencies in the self-employed lending business. Operating expenses increased by 12 per cent, mainly supporting expansion in the region; despite this, the cost efficiency ratio improved by 4.7 percentage points. Net interest income rose by 15 per cent, as steady asset and liability growth was recorded across the region.

In Mexico, net interest income rose by 27 per cent, driven by a strong performance in both asset and liability products. Credit cards, an area in which HSBC has worked to remedy its traditionally underweight position in Mexico, reached a market share of more than 10 per cent, up 3.5 percentage points compared with 2006. This reflected HSBC's efforts to organically grow this portfolio. Growth was enhanced by marketing promotions and portfolio management programmes put in place to improve customer retention and card usage.

Demand for housing remained strong and mortgage lending continued to grow. HSBC's mortgage positioning is based on speed of service and

competitive rates supported by marketing campaigns. HSBC Premier was relaunched in Mexico in 2007 and performed well, increasing cross-sales and income during the year.

On the liabilities side of the balance sheet, both term and demand deposits registered growth in line with market conditions. Overall spreads on Mexican peso-denominated accounts remained relatively stable while spreads on accounts in US dollars narrowed by 141 basis points.

In Brazil, net interest income increased by 7 per cent, as growth in private consumption fuelled a rise in loan volumes. Average customer loans were 28 per cent higher than in 2006. Customer deposits were 23 per cent higher, driven by a sales effort to garner deposits and the favourable economic outlook. Spreads on customer deposits narrowed by 23 basis points.

The vehicle finance loan portfolio grew significantly in the positive economic environment, while spreads narrowed due to competitive pressures. Net interest income on payroll loans grew as volumes expanded. Demand for personal instalment loans also continued to rise, driving net interest income higher on wider spreads.

Net interest income rose by 35 per cent in Argentina, as customer balances grew strongly and four additional months of Banca Nazionale revenues were included. Growth in customer lending reflected expansion in personal loans, car loans and credit cards, supported by cross-selling initiatives and an active marketing campaign. Customer liabilities increased mainly in demand and term deposit products.

Net fee income was 19 per cent higher, primarily from robust business growth across the region.

In Mexico, fee income grew by 35 per cent with the rapidly growing credit card customer base and continued sales of the Tu Cuenta packaged product the main contributors. Cards in force increased by 35 per cent, ATM cash withdrawals by 54 per cent and point of sale billing by 84 per cent during the year, all positively affecting commission income. Stricter guidelines on the imposition of late payment fees also led to higher income. Fees from Tu Cuenta rose strongly, following a 29 per cent growth in the number of accounts. A 6 per cent growth in the ATM network and increased customer activity led to a rise in HSBC's market share in interbank transactions of more than 12 million transactions or 2 percentage points to 38 per cent, resulting in higher interbank fee income.

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### *Latin America > 2007*

In Brazil, fee income rose by 3 per cent on the back of growth in lending balances and a commensurate rise in credit facility fees. Fee income further benefited from re-pricing initiatives, particularly in current account fees.

Fee income in Argentina, higher by 12 per cent, primarily reflected an extra four months of Banca Nazionale revenues. Business growth in bancassurance and credit cards also contributed to improved fees.

The continued growth of insurance operations in the region, through increased product offerings and expanded distribution channels, led to higher insurance premiums and claims.

In Mexico, increased cross-selling activities in the branch network resulted in higher net insurance income, mainly driven by sales of a five-year life assurance product. Refinement of the recognition methodology used in respect of the PVIF long-term insurance contracts resulted in a one-off revenue increment in the first half of 2007.

In Brazil, income grew from higher sales volumes of pension and life assurance products. The growth in the life portfolio was driven by growth of 106 per cent in credit insurance products. Pension portfolio income grew by 48 per cent following targeted sales initiatives. Net insurance claims also grew substantially during the year. Increased premium income in Argentina was generated from higher sales volumes of general insurance and life protection policies, supported by innovative marketing campaigns.

Net gains from financial investments increased significantly, driven by a gain of US\$97 million, following a sale of shares held in a credit bureau, a stock exchange and a derivatives exchange in Brazil.

Loan impairment charges rose by 70 per cent to US\$1.5 billion, mainly due to higher delinquency from seasoned loan growth in Mexico.

Mexico reported a more than threefold increase in loan impairment charges to US\$737 million, driven by higher impairments on credit cards following the targeted expansion in market share, and higher delinquencies from self-employed loan balances. The increase in loan impairment charge is part of the cost of building strong organic growth as portfolios season. Regular reviews are undertaken to improve the quality of new business, based on underwriting experience, improved collection strategies and better managed customer acquisition channels. Credit models were updated during 2007 to adjust to credit behaviour in underlying portfolios.

Loan impairment charges rose only modestly in Brazil, notwithstanding strong asset growth, reflecting the benign credit environment and the application of proactive risk management techniques. Increased loan impairment charges from the vehicle finance, cards, payroll loans and store loans portfolios were partially offset by lower loan impairment charges in overdrafts and personal loans. In Argentina, loan impairment charges grew by US\$14 million, again mainly due to the inclusion of the Banca Nazionale portfolio, as well as organic loan growth.

Operating expenses of US\$3.8 billion were 12 per cent higher, mainly because of activities undertaken in support of product and distribution expansion initiatives, and integrating recent acquisitions.

In Mexico, operating expenses increased by 14 per cent, as non-staff costs rose to support organic business growth. Staff costs were flat as increases to support business growth, mainly in debt collection and call centres, were offset by one-off curtailment and settlement gains from staff transferring out of the bank's defined benefit healthcare scheme to a new defined contribution scheme. Growth in non-staff costs was mainly attributable to



supporting credit card business growth and servicing, strengthening of IT infrastructure and higher marketing spend on product campaigns, promotions and sponsorships. Campaigns included the HSBC Premier relaunch, Tu Cuenta and insurance. The increased popularity of the cash-back facility on the Tu Cuenta account, where a customer receives a rebate on amounts spent by credit or debit cards, also drove up expenses.

In Brazil, operating expenses were 8 per cent higher. Staff costs included one-off expenditure incurred to enable the business to improve operational efficiencies and position itself for future growth. Union-agreed pay rises took effect during 2007. Non-staff expenses, including marketing campaigns, payroll acquisition costs and transactional taxes also increased in support of revenue growth.

Costs in Argentina rose by 39 per cent, mainly from the inclusion of four extra months of Banca Nazionale costs. The rise in expenses reflected both continued investment in infrastructure to support business growth, and general price rises evident in the economy as inflation rose. Increased marketing campaign spending was focused on cards, personal loans and the Premier relaunch.

**Commercial Banking** pre-tax profits rose by 46 per cent to US\$740 million during 2007, mainly driven by significant growth in Brazil and Mexico.

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HSBC's two-pronged objective to become the leading international bank and the best bank for small businesses delivered results as regional customer numbers grew by over 14 per cent. Income from payments and cash management rose by 8 per cent, while the network of International Banking Centres in Argentina, Brazil and Mexico was extended to improve regional coverage. Other developments included the launch of electronic account opening facilities in Mexico and BusinessDirect in Brazil.

Operating income showed an improvement on 2006, although this was partly offset by an increase in costs driven by expansion. As a result, the cost efficiency ratio improved by 0.4 percentage points to 54.3 per cent.

Net interest income rose by 17 per cent, mainly from an increase in both deposits and loans.

In Mexico, net interest income rose by 21 per cent to US\$496 million, reflecting volume growth in deposits, commercial real estate lending, increased support for larger local and global commercial customers and strong volume growth in trade and factoring. Average lending balances rose by 37 per cent, primarily on large corporates, while spreads widened on small business loans. Spreads on deposit accounts narrowed. Customer relationship management campaigns resulted in new customer acquisition and increased cross-sales to existing customers.

In Brazil, net interest income increased by 10 per cent, mainly due to higher income from small and mid-market enterprises in the favourable economic environment. Increases in volumes were notable in the guaranteed account, *giro facil*, working capital facilities and rural loans.

Net interest income increased by 86 per cent in Argentina, due both to strong organic loan and deposit growth, and the inclusion of four additional months of Banca Nazionale revenues. Corporate and mid-market business grew significantly, reflecting the successful integration of the Banca Nazionale network, while the targeting of small and micro enterprises coupled with the launching of new products also helped drive portfolio growth. Customer loans and advances rose by 50 per cent while customer deposits increased by 33 per cent.

Net fee income was 14 per cent higher, driven by robust growth throughout the region.

In Mexico, fee income grew by 13 per cent across a broad product portfolio. Following a strategy to migrate more transactions to internet-based services, payment and cash management transactions increased by 11 per cent and active customers by

19 per cent, resulting in higher income generation. A growth in the number of ATMs led to higher income from ATM interbank charges. Increased use of credit cards at point of sale also increased fee income. Trust fees increased significantly, mainly due to market share gains in the structured products market. Growth in trade services was driven by the Group's geographical presence and enhanced product capabilities, as market share and cross-selling activities increased. International factoring was also successfully launched during 2007.

In Brazil, fee income rose by 11 per cent, mainly on small and micro enterprises. Payments and cash management income increased, mainly on higher volumes. Current account income increased as a result of a re-pricing exercise and a rise in volumes. Fees from loans and funds under management also grew on higher volumes. More than 110,000 products were sold over e-channels, a significant increase on the previous year.

In Argentina, HSBC increased fee income by 48 per cent, primarily due to an additional four months of Banca Nazionale revenues combined with higher transaction volumes. The main product drivers behind the increase were current accounts, which rose by 38 per cent, and trade services, which grew by 39 per cent on higher volumes, placing HSBC among the top three banks in imports and exports in Argentina.

Trading income rose on the back of higher volumes of foreign exchange transactions and sales of treasury products in Brazil, which reflected higher market share and favourable market conditions. Foreign exchange trading income also increased in Argentina.

Net gains from financial investments rose by US\$47 million, driven by a gain of US\$45 million following a sale of shares held in a credit bureau, a stock exchange and a derivatives exchange in Brazil.

Loan impairment charges were 28 per cent lower at US\$212 million.

In Mexico, HSBC recorded a net decrease in loan impairment charges as increased delinquency rates in the small and medium-sized business portfolios were offset by impairment allowance releases. Regular reviews aimed at strengthening consumer credit management and collections were put in place to better manage delinquency rates as the portfolio matures. Credit models were updated during 2007 to adjust to credit behaviour in underlying portfolios. Products with high credit losses were discontinued or restructured.

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HSBC HOLDINGS PLC

## Report of the Directors: Business Review

(continued)

*Latin America > 2007 / 2006*

Loan impairment charges rose by 4 per cent in Brazil despite a substantial growth in assets. This improved performance was mainly attributable to the small business segment and resulted from changes to credit initiation and collection strategies implemented during the year. In Argentina, HSBC reported a net release of loan impairment allowances following an improvement in the country's economic performance during 2007 and increased collections of non-performing loans.

In line with Group strategy to expand in fast growing economies, operating expenses in the Latin America region rose by 21 per cent to US\$1.1 billion.

In Mexico, operating expenses increased by 22 per cent, largely driven by higher transaction costs. Staff cost rises reflected an increase in salary and performance awards in line with profit generation. Growth in non-staff costs was attributable to higher marketing expenditure and a rise in transaction costs from increased business volumes.

In Brazil, operating expenses rose by 15 per cent following implementation of a union agreement on staff remuneration and one-off expenses incurred to improve future operational efficiencies. Non-staff costs, including transactional taxes, increased broadly in line with business expansion and revenue growth.

In Argentina, costs rose by 53 per cent, again mainly driven by the inclusion of four extra months of Banca Nazionale costs. Excluding this, expenses rose reflecting continued investment in support of business growth and the general price increase evident in the local market.

**Global Banking and Markets** in Latin America reported a pre-tax profit of US\$517 million, which represented an increase of 1 per cent from 2006. Robust growth in net interest income and fees was partially offset by a decrease in trading income and an increase in costs relating to regional business expansion. Overall, this led to a deterioration in the cost efficiency ratio to 48.9 per cent.

Total operating income increased by 13 per cent to US\$1.0 billion. This was chiefly driven by strong revenue growth in Brazil, which more than offset reduced trading income in Mexico, in comparison with the latter's strong performance in 2006.

Net interest income increased by 13 per cent, driven by cross-referrals from Commercial Banking and an increased volume of deposit balances in the securities services business as the strong performance of Brazilian equity markets attracted foreign buyers. In Argentina, net interest income rose through an additional contribution from Banca Nazionale and higher spreads on customer loans.

Net fee income rose by 34 per cent to US\$250 million, driven by a strong performance in Brazil. HSBC Global Asset Management revenues increased as a result of strong returns from funds with performance fees and the success of selling locally manufactured products into Asian markets. Increased IPO activity in Brazil boosted fees from financing and capital markets, both from advisory services and from underwriting new listings. Securities services also performed well in the region as new business volumes and strong local equity markets drove a 63 per cent increase in assets under custody.

Net income from trading activities decreased by 14 per cent to US\$182 million, driven by performance in Mexico, where there were reduced revenue opportunities in Credit and Rates due to the relatively flat yield curve. This was partly offset by income growth from foreign exchange trading, driven by continuing market

volatility.

Gains less losses from financial investments increased by 10 per cent, driven by a gain of US\$46 million following a sale of shares held in a credit bureau, a stock exchange and a derivatives exchange in Brazil. These were partially offset by a lower level of disposals in Mexico in 2007.

There were continued but lower impairment releases, with a small number of significant releases in Argentina relating to impairments that arose during the 2001 debt crisis offsetting the non-recurrence of a large release in 2006 in Mexico.

Operating expenses increased by 23 per cent to US\$481 million, and reflected HSBC's investment in increasing operational capabilities in Brazil, cost growth in Argentina following the inclusion of Banca Nazionale and continued investment in infrastructure to support business growth. This caused the cost efficiency ratio to deteriorate by 4.1 percentage points.

**Private Banking** reported a pre-tax profit of US\$25 million, an increase of 47 per cent. The cost efficiency ratio improved by one percentage point to 64.8 per cent. The upward trend in cross-referrals continued, particularly in Brazil, with inward referrals contributing US\$495 million to total client assets.

Overall, revenues increased by 42 per cent to US\$71 million, driven by Mexico and Brazil. In Mexico, balance sheet growth and brokerage fees drove revenues up. Higher investment in funds and cross-referrals in Brazil also contributed to the rise in fee income.

Client assets grew by 62 per cent to US\$11.6 billion, of which US\$1.8 billion represented

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net new money. The increase in net new money was driven by the acquisition of new clients, particularly in Brazil and Mexico, improved product offerings and cross-referrals from other customer groups in Brazil.

Operating expenses increased by 40 per cent to US\$46 million to support business expansion, particularly in Brazil, and to create a platform for future growth in the region.

Profit before tax of US\$3 million was reported within **Other**.

Year ended 31 December 2006 compared with year ended 31 December 2005

### **Economic briefing**

**Mexico**'s GDP growth improved significantly in 2006 to 4.8 per cent from 3.0 per cent in 2005, mostly in response to increased external demand from the US. Commercial bank credit continued to recover strongly, with over 80 per cent growth in real mortgage loans. By the end of 2006, headline inflation had increased to 3.8 per cent from 3.0 per cent earlier in the year, largely as a result of increases in agricultural supply prices. Record oil revenues, combined with high non-oil export growth and increasing inward remittances from Mexicans working outside the country produced an almost balanced current account for the year. Significant capital inflows, including an estimated US\$18 billion in foreign direct investment, enabled the Government to reduce its external debt by more than US\$12 billion and the Bank of Mexico to increase foreign exchange reserves.

In **Brazil**, GDP is expected to have grown by 2.6 per cent in 2006 compared with 2.3 per cent in 2005. Growth was driven by domestic demand, with private consumption increasing by 3.8 per cent and capital spending by 5.9 per cent. Net exports, by contrast, fell by 18 per cent in the first three quarters of the year compared with the same period in 2005, as the increase in domestic demand translated into higher imports rather than an expansion of output. The unemployment rate averaged 10.0 per cent in 2006, slightly up from 9.8 per cent averaged in 2005. Inflation continued to decline, to 3.1 per cent in 2006, compared with 5.7 per cent in 2005 and, as a result, the Central Bank continued to ease monetary policy. Overnight rates fell to 13.25 per cent in December 2006 from 17.25 per cent a year before. The trade balance continued to be robust, with a

surplus of US\$46.1 billion in 2006, just above the amount achieved in 2005.

In **Argentina**, real GDP growth in 2006 exceeded 8.3 per cent and, after growing for four consecutive years at an average rate of approximately 9 per cent, the country's GDP was nearly 15 per cent above 1998, when its recession began. The strong growth was due to a competitive exchange rate, a strong fiscal stance and a favourable business environment, which HSBC expects to continue in 2007. The main potential constraint on growth remains the risk of disruption in energy supply, where there has been a lack of investment and limited price adjustments for residential consumers since 2001/2. Inflation was approximately 10 per cent at the end of 2006, having tripled in the past three years, though it was below its peak of more than 12 per cent in 2005. Interest rates rose steadily in 2006 and the peso weakened slightly against the US dollar. Given Argentina's higher inflation rate, however, the exchange rate appreciated in real terms.

### **Review of business performance**

HSBC's operations in Latin America reported a pre-tax profit of US\$1.7 billion compared with US\$1.6 billion in 2005, an increase of 8 per cent. On an underlying basis, pre-tax profits rose by 5 per cent. Growth in profitability was constrained by the non-recurrence of one-off coverage bond receipts and other items related to the 2001 sovereign debt default and subsequent pesification in Argentina, which added US\$122 million to 2005 profits. In addition, a gain of US\$89 million from the sale of the property and casualty insurance business, HSBC Seguros de Automoveis e Bens Limitada, to HDI Seguros S.A., was recorded in 2005. Excluding these prior year profits, and on an underlying basis, profit before tax increased by 21 per cent, with net operating income increasing by 15 per cent and operating expenses by 12 per cent. Global Banking and Markets delivered a strong performance, driven by growth in fee and trading income, with notable success in bringing Latin American borrowers to global capital markets. Commercial Banking also grew well as domestic economies expanded. During 2006, HSBC made two significant acquisitions in the region. In May, HSBC acquired the Argentine banking operations of Banca

Nazionale to build its distribution capabilities and, in November, HSBC Bank Panama in Central America, adding markets in five countries new to the Group.

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HSBC HOLDINGS PLC

**Report of the Directors: Business Review**

(continued)

*Latin America > 2006***Reconciliation of reported and underlying profit before tax**

Year ended 31 December 2006 compared with year ended 31 December 2005

	2005 as reported	Currency translation <sup>1</sup>	2005 at 2006 exchange rates	Acquisitions and disposals <sup>2</sup>	Underlying change	2006 as reported	Reported change	Underlying change
<b>Latin America</b>	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m	%	%
Net interest income	3,342	165	3,507	77	613	4,197	26	17
Net fee income	1,191	53	1,244	38	348	1,630	37	28
Other income <sup>3</sup>	1,173	56	1,229	25	(246)	1,008	(14)	(20)
Net operating income <sup>4</sup>	5,706	274	5,980	140	715	6,835	20	12
Loan impairment charges and other credit risk provisions	(676)	(63)	(739)	(18)	(181)	(938)	(39)	(24)
Net operating income	5,030	211	5,241	122	534	5,897	17	10
Operating expenses	(3,426)	(196)	(3,622)	(92)	(452)	(4,166)	(22)	(12)
Operating profit	1,604	15	1,619	30	82	1,731	8	5
Income from associates	□	□	□	4	□	4	□	□
Profit before tax	1,604	15	1,619	34	82	1,735	8	5



For footnotes, see page 130.

The following commentary is on an underlying basis.

**Personal Financial Services** reported a pre-tax profit of US\$800 million, a rise of 1 per cent over 2005, which had benefited from a US\$89 million gain on the sale of the Group's property and casualty insurance business in Brazil. Adjusting for this, pre-tax profits grew by 16 per cent, driven by 12 per cent growth in revenues and 10 per cent growth in costs. The underlying improvement in revenues was led by strong asset and deposit growth together with higher fee income, offset in part by consequential expense growth and a rise in impairment charges as the loan book both grew and seasoned.

In Mexico, profit before tax rose by 10 per cent. During 2006, 56,000 Personal Financial Services customers were transferred to the Commercial Banking customer group, where HSBC is better placed to meet their banking requirements. Adjusting for this, profits were 20 per cent higher, driven by strong balance sheet growth and improved fee income.

Adjusting for the gain in 2005 from the sale of the property and casualty business, pre-tax profits were 46 per cent higher in Brazil. The strong domestic economy stimulated robust growth in lending and a rise in the number of current account holders. During the year, a new and innovative internet banking service *Meu HSBC* (My HSBC) was introduced to Personal Financial Services customers, allowing them to conduct different types of transactions online using the same password as their ATM card.

In Argentina, profit before tax was marginally higher, with strong balance sheet growth, higher fees and improved revenues from the insurance business. This was largely offset by increased loan impairment charges and cost growth incurred in support of business expansion as HSBC prepared for an improving domestic economic environment.

Net interest income rose by 11 per cent to US\$3.1 billion, largely from balance sheet growth partly offset by lower deposit spreads.

In Mexico, net interest income increased by 12 per cent to US\$1.2 billion. Adjusting for the effect of customer account transfers to Commercial Banking, net interest income rose by 20 per cent, driven by strong growth in credit card and mortgage balances and increases in deposits which were generated by the ongoing success of the Tu Cuenta product. Overall, asset spreads improved as the relative increase in higher margin card balances led to a favourable change in the product mix. By contrast, deposit spreads narrowed as interest rates declined.

Excluding customer account transfers, average deposit balances in Mexico rose by 10 per cent. HSBC continued to be one of the market leaders with respect to balance growth, despite fierce competition from other banks, improving its market share by 35 basis points. A strong increase in low-cost deposits was reflective of the continuing success of Tu Cuenta, the first integrated financial services product of its kind offered locally, with nearly 400,000 new accounts opened in 2006. HSBC Premier performed well as 84,000 new customers were added during the year. Premier deposits

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represented over one third of the total personal deposit base at 31 December 2006. The income benefit from higher deposit balances was partly mitigated by reduced spreads in the falling interest rate environment, notwithstanding the positive shift in mix from growth in non-interest bearing deposit balances.

The credit card market in Mexico was buoyant in 2006 and HSBC's business performed very successfully with average balances doubling to US\$886 million. Various initiatives were implemented to develop the business, most notably cross-sales to Tu Cuenta customers, targeted customer relationship campaigns to existing clients, successful portfolio management strategies and promotions, development of new sales channels and improvements in card activation times. These initiatives helped HSBC become the market leader in credit card balance growth, improving market share by 2.3 per cent. The number of cards in circulation reached 1.7 million at the year end, representing an increase of 76 per cent.

Demand for housing from first time buyers remained strong in Mexico, and market conditions continued to be highly competitive. Average mortgage balances rose by 81 per cent to US\$969 million, reflecting HSBC's competitive pricing and innovation in product design. HSBC was the first bank in Mexico to market pre-approved online mortgages, and enhanced this offering with the subsequent introduction of Mortgage Express Approval, which provides customers with much faster access to details concerning the loan amount, duration and monthly payments at the point of application. Improvements in the processing of mortgage applications, upgraded customer service and increased marketing activity also contributed to the rise in lending balances. The income benefits of balance growth were partly offset by narrower spreads, driven by the highly competitive market conditions.

As the Mexican economy grew strongly, there was robust growth in personal and payroll lending balances. The introduction of a dedicated and mobile sales force during the second half of 2006 to expand distribution capabilities led to a fourfold increase in average personal lending balances during the year. This initiative also helped to reduce time to market, increase cross-sales and, through closer interaction with the branch network, improve client coverage. The popularity of the personal loan product, where customers apply directly via HSBC's extensive and well-positioned ATM network grew, and this was the key driver behind a 37 per cent rise in average payroll loan balances.

In Brazil, net interest income increased by 9 per cent as lower inflation and the improving domestic economy triggered a rise in demand for credit which, in turn, contributed to strong lending growth. Average loan balances were 18 per cent higher, driven by rising customer numbers and increases in vehicle financing, pension and payroll loans. On the liability side, there was a 7 per cent rise in current account holders, largely driven by growth in the number of customers with payroll loans and greater levels of sales activity.

Average vehicle finance balances in Brazil rose by 36 per cent, led by continued portfolio growth as HSBC strengthened its relationships with car dealerships. The combined pension and payroll loan portfolios registered an 84 per cent increase in average balances, a consequence of increased borrowings per customer, portfolio acquisitions, and growing customer demand for these products. Spreads also improved, largely as a result of lower funding costs, which augmented the positive income benefits of balance growth. Average card balances rose by 19 per cent, with an increase of 27 per cent in the number of cards in issue, reflecting the launch of various initiatives aimed at improving retention, activation and utilisation. Spreads improved from lower funding costs and price increases initiated in the second half of 2005, complementing the benefits derived from higher lending volumes.

In Argentina, net interest income grew by 12 per cent, primarily driven by increased demand for credit card, other personal and motor vehicle lending. This was largely attributable to more effective promotional activity and productivity improvements in the telemarketing and branch channels. Higher funding costs, however, resulted in a narrowing of lending spreads, offsetting volume benefits. Deposit balances rose, reflecting the increased emphasis placed on growing liability products, the benefit from which was augmented by a widening of spreads.

Net fee income was 25 per cent higher, reflecting strong growth across the region generally.

Fee income grew by 21 per cent in Mexico, largely due to higher credit card and Tu Cuenta income. Fee income from cards rose by 51 per cent, reflecting a significant growth in the number of cards in circulation and

improvements made in reducing activation times. The improvement in Tu Cuenta income was driven by sales of over 1 million new accounts and re-pricing initiatives. In order to capture a higher volume of ATM revenues, HSBC added 372 new machines to its already well-positioned network, which increased ATM fees from greater levels of transactional activity and a 22 per cent rise

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HSBC HOLDINGS PLC

## **Report of the Directors: Business Review** (continued)

*Latin America > 2006*

in transactions from non-HSBC customers. Growth in mutual fund fees was mainly driven by higher sales volumes and expanded product offerings in the stronger economic environment.

Fee income in Brazil rose by 25 per cent, largely from increased current account fees, reflecting growth in customer numbers, greater transaction volumes and re-pricing initiatives. Higher payroll and vehicle balances also led to increased fees from lending activities. In Argentina, higher credit card fees from balance growth, re-pricing initiatives on savings accounts, and the discontinuance of a free current account promotion led to an improvement in fee income.

Across the region, HSBC's insurance businesses continued to perform well. Sales of insurance products in Mexico remained strong, with increased cross-selling through the branch network of simple insurance products together with other Personal Financial Services products containing insurance components. This led to a 19 per cent rise in net premiums, mainly in respect of individual life insurance products. In Brazil, excluding the effect of the property and casualty insurance business sold in 2005, insurance revenues rose, largely from life and pension products. In Argentina, increased advertising, partnerships with established local consumer brands and internal cross-selling initiatives led to a rise in motor, home and extended-warranty insurance premium income. Life and annuity premiums also increased in line with higher customer salaries. The "Maxima" pension funds business delivered higher revenues helped by improvements in the economic climate and greater levels of employment.

Lower other operating income reflected the non-recurrence of profit on the sale of HSBC's Brazilian property and casualty insurance business.

Loan impairment charges and other credit risk provisions rose by 15 per cent to US\$764 million as lending grew and the loan book seasoned. In Mexico, the higher charge was primarily driven by the growth in credit card lending. In Brazil, loan impairment charges increased modestly, driven by growth in vehicle finance, instalment loans (*credito parcelado*) and credit card lending. As the credit environment weakened during the first half of the year, various measures were taken to mitigate the effects. These included tightening lending criteria, enhancing credit analytics, revising the collection policy, prioritising secured lending ahead of unsecured advances and strengthening credit operations. Following implementation of these measures, several key credit indicators showed improvement.

Operating expenses rose by 10 per cent. In Mexico, expense growth of 10 per cent was mainly driven by increased staff costs. This largely reflected the recruitment of 2,200 employees to improve customer service levels in branches and grow sales. Incentive costs increased as profits rose, and marketing costs grew as a result of various promotional campaigns. The continued expansion of the branch network and ATM infrastructure, together with the new HSBC headquarters building in Mexico City, led to increases in IT, premises and equipment costs.

In Brazil, expenses were 10 per cent higher. As in Mexico, this reflected the cost of new employees recruited to support business expansion, including the strengthening of credit operations, and new branch openings. This, together with annual pay rises and increased incentive payments, triggered a 13 per cent growth in staff costs. Advertising costs rose to promote brand awareness, while an HSBC Premier promotion led to higher marketing costs.

Costs grew by 26 per cent in Argentina, with higher staff costs driven by union-agreed pay rises in 2005, and increased incentives and commissions paid in light of revenue growth. Marketing costs also increased to support the launch of various promotions and campaigns.

**Commercial Banking** reported pre-tax profits of US\$451 million, 17 per cent higher than in 2005. Growth in net operating income before loan impairment charges was strong at 26 per cent as domestic economies in the

region grew and HSBC built market share. Cost growth in support of this expansion was held within revenue growth and the cost efficiency ratio improved by 2.5 per cent.

Net interest income rose by 24 per cent, largely driven by business expansion in Mexico and Brazil.

In Mexico, net interest income rose by 49 per cent, reflecting asset and deposit growth, in part due to the transfer of the 56,000 customers from Personal Financial Services noted above. As HSBC extended its presence in the small and middle market business segments, average deposit balances increased by 65 per cent (31 per cent excluding the transferred customer accounts), although the benefit of this volume growth was partly mitigated by lower deposit spreads in a falling rate environment.

Lending balances in Mexico were 41 per cent higher, primarily driven by strong demand in the rapidly growing real estate and residential construction sectors. During the final quarter of the year, HSBC opened an International Banking Centre to develop cross-border business for global

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Commercial Banking customers, with 75 business accounts acquired since its inception. Attention placed on higher yielding small and middle market businesses, following refinements made to the customer segmentation strategy, contributed to asset growth as greater emphasis was put on increasing revenues from this segment. These volume benefits were augmented by improved lending spreads from lower funding costs in the falling interest rate environment, which offset reduced yields.

In Brazil, net interest income was 12 per cent higher. Overall, lending balances rose by 16 per cent, primarily driven by small and middle market customers. The recruitment of additional relationship managers and sales staff, investments made in receivables financing and greater levels of promotional activity all combined to build HSBC's position in this market segment. There was ongoing success from the *giro fácil* product, offering both revolving loan and overdraft facilities, with average balances recording a 13 per cent increase. Spreads widened as interest rates fell, further augmenting the income benefits of higher lending volumes.

A 42 per cent rise in net interest income in Argentina was primarily attributable to strong asset and liability growth. Average lending and deposit balances increased by 39 per cent and 19 per cent respectively, as customer numbers rose, particularly to the small and micro businesses, helped by favourable economic conditions and investment in new sales channels. Asset spreads declined, however, due to competitive market pressures on pricing, partly offsetting the income benefits of higher lending volumes. By contrast, deposit spreads improved.

Net fee income was 36 per cent higher, driven by robust increases across Mexico, Brazil and Argentina.

In Mexico, fee income rose by 28 per cent with notable success in increasing cross-sales activity. Growth in customer numbers contributed to higher transactional volumes which, combined with an expanded and improved product offering plus increased marketing activity and re-pricing initiatives, led to a 41 per cent rise in income from payments and cash management services. The Estimulo product offering, comprising a packaged suite of seven different products including a loan facility, continued to perform well with fee income nearly trebling compared with 2005. During the third quarter, a similar product, Estimulo Empresarial, was launched, targeting upper-end small business customers. This product encompasses a suite of eleven different services and since its introduction more than 165 clients have been signed, generating US\$50 million of new loans. HSBC's share of the

trade services market continued to grow, building on the Group's international network and product capabilities. Fees from international factoring and domestic invoicing payment products also rose, as new products were successfully piloted and marketed to existing clients. The signing of new merchant customers led to higher transaction volumes and a subsequent 60 per cent rise in card acquiring fees.

In Brazil, fee income rose by 47 per cent as effective cross-selling led to an increase in the average number of products held per customer. Current account fee income grew from higher levels of transactional activity and tariff increases implemented in 2005. Pricing changes introduced part-way through 2006 led to higher revenues from payment and cash management services. There was improved fee income from assets under management, and additional marketing to promote trade products led to a rise in trade services fees.

Fee income in Argentina was 27 per cent higher, primarily from increases in account and trade services along with payments and cash management fees.

Loan impairment charges and other credit risk provisions doubled, reflecting strong lending growth, a higher proportion of small and micro business lending, and the seasoning of the portfolio.

In Mexico, strong growth in the lower-end small and micro business lending balances led to increased loan impairment charges during the year.

A 41 per cent rise in Brazil again reflected large increases in small and micro business lending balances and higher delinquency rates as the portfolio seasoned. This led to a 12 basis point increase in the proportion of impaired loans to assets. Various actions were undertaken to manage the effects of the weakening credit environment, with debt collection operations enhanced and closer cooperation forged between sales and collections staff. Changes were also made to underwriting criteria, coupled with revisions to sales staff incentive schemes. Following these measures, an improvement in credit quality was seen and charges reduced in the second half of the year compared with the first half. In Argentina, releases were lower than in 2005.

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Operating expenses of US\$822 million were 21 per cent higher than in 2005, as businesses expanded strongly across Latin America.

In Mexico, operating expenses rose by 26 per cent, largely driven by higher transactional volumes, new clients acquired and increased lending activity. Non-staff costs were higher, reflecting the marketing and IT-related support to business growth.

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HSBC HOLDINGS PLC

**Report of the Directors: Business Review**

(continued)

**Latin America > 2006 / Profit/(loss) before tax by customer group**

In Brazil, expenses grew by 19 per cent, also largely from higher staff, marketing and administrative costs. Business expansion activities in the small and middle market customer segments followed the recruitment of 270 additional employees and this, together with union-agreed pay increases, were the principal drivers behind the 21 per cent rise in staff costs. Continued enlargement of the branch network, the opening of an International Banking Centre and new sales offices combined with increases in marketing and administration costs in support of business expansion, contributed further to cost growth. Costs in Argentina rose by 30 per cent, primarily staff costs which reflected annual pay increases and additional headcount driven by accelerated business activity. In supporting the growth of the business, there was increased expenditure on branding, technology and distribution, with ongoing improvements made to the internet banking service.

**Global Banking and Markets** reported a pre-tax profit of US\$475 million, an increase of 30 per cent compared with 2005. HSBC's strong global presence, together with selective investment in extending service and delivery capabilities in the region, resulted in higher volumes with new and existing clients. The cost efficiency ratio improved moderately.

Total operating income increased by 23 per cent to US\$846 million compared with 2005. In Brazil, balance sheet management revenues grew significantly as relatively low short-term interest rates reduced funding costs. In Argentina, higher net interest income reflected an increase in index linked securities portfolios and a growing demand for credit as regional economies and market confidence continued their recent improvement. By contrast, in Mexico, balance sheet management revenues were constrained by a flattening of the interest rate curve and relatively stable market conditions.

Net interest income from payments and cash management rose by 64 per cent as customer volumes grew, reflecting new client mandates.

Net fee income increased by 29 per cent to US\$167 million, predominantly through increased performance-related fees on emerging markets funds managed by HSBC Global Asset Management. Income in securities services benefited from strong equity market indices and growth in new business as assets under custody increased significantly to US\$89 billion.

In Mexico, a 32 per cent rise in payments and cash management fees was driven by a wider product offering and the leveraging of established credit related products and services.

Higher revenues from trading activities in Brazil flowed from marketing the wider product range and enhanced delivery capabilities of Global Markets. Greater volatility in local markets resulted in higher business volumes in foreign exchange and currency derivatives. In Argentina, economic and political stability increased liquidity in the market with foreign exchange trading benefiting from greater customer activity. In Mexico, a 23 per cent increase in trading income was driven by a combination of successful positioning for a flattening yield curve and higher client volumes delivered through the extended suite of products.

A net release of US\$26 million in loan impairment charges reflected a stable corporate credit environment and the implementation of improved risk management strategies in Mexico.

Operating expenses rose by 20 per cent to US\$346 million, primarily driven by higher staff costs reflecting increased performance-related incentives in line with revenue growth, and pay rises agreed with local unions. Higher operational costs reflected increased volumes, particularly in payments and cash management and securities services businesses, and the continued investment in building the Global Banking and Markets



business in the region.

**Private Banking** reported a pre-tax profit of US\$14 million, a significant increase on 2005. Profit growth was strong in both Mexico and Brazil. In Brazil, revenue and cost benefits arose from initiatives to join up the business, including cross-referrals with other customer groups. Strong revenue growth in the newly launched business in Mexico resulted primarily from greater client participation in capital markets, notably commercial paper placements, which contributed towards a 53 per cent rise in fee income. This strong performance was reflected in the cost efficiency ratio which improved by 23.4 percentage points to 65.9 per cent.

Within **Other**, the non-recurrence of coverage bond receipts and other items related to the 2001 Argentinean sovereign debt crisis led to lower earnings.

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Profit/(loss) before tax and balance sheet data by customer group and global business

## Year ended 31 December 2007

<b>Latin America</b>	<b>Personal Financial Services US\$m</b>	<b>Commercial Banking US\$m</b>	<b>Global Banking &amp; Markets US\$m</b>	<b>Private Banking US\$m</b>	<b>Other US\$m</b>	<b>Inter- segment elimination<sup>14</sup> US\$m</b>	<b>Total US\$m</b>
Net interest income	3,983	1,407	410	20	3	(247)	5,576
Net fee income	1,372	485	250	40	6	□	2,153
Trading income excluding net interest income	67	39	164	2	□	□	272
Net interest income on trading activities	10	1	18	□	□	247	276
Net trading income <sup>5</sup>	77	40	182	2	□	247	548
Net income from financial instruments designated at fair value	314	□	6	□	□	□	320
Gains less losses from financial investments	120	51	82	1	(1)	□	253
Gains arising from dilution of interests in associates	□	□	□	□	11	□	11
Dividend income	5	2	2	□	□	□	9
Net earned insurance premiums	1,448	66	80	□	□	□	1,594
Other operating income	145	69	31	8	12	(37)	228
<b>Total operating income</b>	<b>7,464</b>	<b>2,120</b>	<b>1,043</b>	<b>71</b>	<b>31</b>	<b>(37)</b>	<b>10,692</b>
Net insurance claims <sup>6</sup>	(1,330)	(37)	(60)	□	□	□	(1,427)
<b>Net operating income<sup>4</sup></b>	<b>6,134</b>	<b>2,083</b>	<b>983</b>	<b>71</b>	<b>31</b>	<b>(37)</b>	<b>9,265</b>
Loan impairment (charges)/ recoveries and other credit risk provisions	(1,492)	(212)	13	□	(6)	□	(1,697)
<b>Net operating income</b>	<b>4,642</b>	<b>1,871</b>	<b>996</b>	<b>71</b>	<b>25</b>	<b>(37)</b>	<b>7,568</b>
Total operating expenses	(3,758)	(1,132)	(481)	(46)	(22)	37	(5,402)

<b>Operating profit</b>	<b>884</b>	<b>739</b>	<b>515</b>	<b>25</b>	<b>3</b>	<b>□</b>	<b>2,166</b>
Share of profit in associates and joint ventures	<b>9</b>	<b>1</b>	<b>2</b>	<b>□</b>	<b>□</b>	<b>□</b>	<b>12</b>
<b>Profit before tax</b>	<b>893</b>	<b>740</b>	<b>517</b>	<b>25</b>	<b>3</b>	<b>□</b>	<b>2,178</b>
	%	%	%	%	%		%
Share of HSBC's profit before tax	<b>3.7</b>	<b>3.1</b>	<b>2.1</b>	<b>0.1</b>	<b>□</b>		<b>9.0</b>
Cost efficiency ratio	<b>61.3</b>	<b>54.3</b>	<b>48.9</b>	<b>64.8</b>	<b>71.0</b>		<b>58.3</b>
	<b>US\$m</b>	<b>US\$m</b>	<b>US\$m</b>	<b>US\$m</b>	<b>US\$m</b>		<b>US\$m</b>
<b>Balance sheet data<sup>7</sup></b>							
Loans and advances to customers (net)	<b>21,680</b>	<b>16,243</b>	<b>9,935</b>	<b>65</b>	<b>□</b>		<b>47,923</b>
Total assets	<b>34,829</b>	<b>20,928</b>	<b>43,012</b>	<b>260</b>	<b>27</b>		<b>99,056</b>
Customer accounts	<b>30,628</b>	<b>15,524</b>	<b>13,950</b>	<b>1,190</b>	<b>□</b>		<b>61,292</b>
The following assets and liabilities were significant to Global Banking and Markets:							
□ loans and advances to banks (net)			<b>10,339</b>				
□ trading assets, financial instruments designated at fair value, and financial investments			<b>18,950</b>				
□ deposits by banks			<b>2,830</b>				

For footnotes, see page 130.

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HSBC HOLDINGS PLC

**Report of the Directors: Business Review**

(continued)

*Latin America > Profit/(loss) before tax by customer group*Profit/(loss) before tax and balance sheet data by customer group and global business (*continued*)

Year ended 31 December 2006

<b>Latin America</b>	Personal		Global			Inter-	Total
	Financial Services US\$m	Commercial Banking US\$m	Banking & Markets US\$m	Private Banking US\$m	Other US\$m	segment elimination <sup>14</sup> US\$m	
Net interest income/(expense)	3,057	1,037	325	13	(2)	(233)	4,197
Net fee income	1,053	387	167	23	□	□	1,630
Trading income excluding net interest income	61	21	218	1	□	□	301
Net interest income/(expense) on trading activities	14	5	(16)	□	□	233	236
Net trading income <sup>5</sup>	75	26	202	1	□	233	537
Net income/(expense) from financial instruments designated at fair value	227	□	11	□	(1)	□	237
Gains less losses from financial investments	11	1	72	□	□	□	84
Dividend income	5	1	□	□	□	□	6
Net earned insurance premiums	992	27	59	□	(2)	□	1,076
Other operating income	74	7	10	4	14	(18)	91
<b>Total operating income</b>	<b>5,494</b>	<b>1,486</b>	<b>846</b>	<b>41</b>	<b>9</b>	<b>(18)</b>	<b>7,858</b>
Net insurance claims <sup>6</sup>	(957)	(16)	(51)	□	1	□	(1,023)
<b>Net operating income<sup>4</sup></b>	<b>4,537</b>	<b>1,470</b>	<b>795</b>	<b>41</b>	<b>10</b>	<b>(18)</b>	<b>6,835</b>
Loan impairment (charges)/ recoveries and other credit risk provisions	(764)	(197)	26	□	(3)	□	(938)
<b>Net operating income</b>	<b>3,773</b>	<b>1,273</b>	<b>821</b>	<b>41</b>	<b>7</b>	<b>(18)</b>	<b>5,897</b>

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Total operating expenses	(2,977)	(822)	(346)	(27)	( 12)	18	(4,166)
Operating profit/(loss)	796	451	475	14	(5)	□	1,731
Share of profit in associates and joint ventures	4	□	□	□	□	□	4
Profit/(loss) before tax	800	451	475	14	(5)	□	1,735

%                      %                      %                      %                      %                      %

Share of HSBC's profit before tax	3.6	2.0	2.2	0.1	□		7.9
Cost efficiency ratio	65.6	55.9	43.5	65.9	120.0		61.0
	US\$m	US\$m	US\$m	US\$m	US\$m		US\$m

Balance sheet data<sup>7</sup>

Loans and advances to customers (net)	16,165	11,463	8,147	16	□		35,791
Total assets	28,053	16,244	36,333	90	51		80,771
Customer accounts	25,200	13,754	11,685	222	□		50,861

The following assets and liabilities were significant to Global Banking and Markets:

□ loans and advances to banks (net)			9,704				
□ trading assets, financial instruments designated at fair value, and financial investments			15,882				
□ deposits by banks			3,115				

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Year ended 31 December 2005

	Personal Financial Services US\$m	Commercial Banking US\$m	Global Banking & Markets US\$m	Private Banking US\$m	Other US\$m	Inter- segment elimination <sup>14</sup> US\$m	Total US\$m
<b>Latin America</b>							
Net interest income	2,580	767	292	10	22	(329)	3,342
Net fee income	790	263	122	14	2	□	1,191
Trading income excluding net interest income	56	9	151	3	1	□	220
Net interest expense on trading activities	□	□	(13)	1	□	329	317
Net trading income <sup>5</sup>	56	9	138	4	1	329	537
Net income from financial instruments designated at fair value	174	□	9	□	3	□	186
Gains less losses from financial investments	35	□	10	□	35	□	80
Dividend income	5	□	□	□	□	□	5
Net earned insurance premiums	794	23	57	□	(3)	□	871
Other operating income/(expense)	188	18	25	(1)	56	□	286
<b>Total operating income</b>	<b>4,622</b>	<b>1,080</b>	<b>653</b>	<b>27</b>	<b>116</b>	<b>□</b>	<b>6,498</b>
Net insurance claims <sup>6</sup>	(734)	(13)	(45)	□	□	□	(792)
<b>Net operating income<sup>4</sup></b>	<b>3,888</b>	<b>1,067</b>	<b>608</b>	<b>27</b>	<b>116</b>	<b>□</b>	<b>5,706</b>
Loan impairment (charges)/recoveries and other credit risk provisions	(600)	(89)	11	(2)	4	□	(676)
<b>Net operating income</b>	<b>3,288</b>	<b>978</b>	<b>619</b>	<b>25</b>	<b>120</b>	<b>□</b>	<b>5,030</b>
<b>Total operating expenses</b>	<b>(2,502)</b>	<b>(621)</b>	<b>(273)</b>	<b>(24)</b>	<b>(6)</b>	<b>□</b>	<b>(3,426)</b>
<b>Operating profit</b>	<b>786</b>	<b>357</b>	<b>346</b>	<b>1</b>	<b>114</b>	<b>□</b>	<b>1,604</b>
Share of profit/(loss) in associates and joint	□	□	1	□	(1)	□	□

ventures

Profit before tax	786	357	347	1	113	1,604
	%	%	%	%	%	%
Share of HSBC's profit before tax	3.8	1.7	1.7	0	0.5	7.7
Cost efficiency ratio	64.4	58.2	44.9	88.9	5.2	60.0
	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m

Balance sheet data<sup>7</sup>

Loans and advances to customers (net)	9,233	6,424	6,012	12	0	21,681
Total assets	15,723	9,491	28,509	53	1,611	55,387
Customer accounts	17,302	4,703	8,661	102	221	30,989

The following assets and liabilities were significant to Global Banking and Markets:

Loans and advances to banks (net)			7,410			
Trading assets, financial instruments designated at fair value, and financial investments			13,067			
Deposits by banks			1,858			

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HSBC HOLDINGS PLC

## Report of the Directors: Business Review

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*Products and services*

### Other information

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#### Products and services

##### Personal Financial Services

Personal Financial Services provides over 125 million individual and self-employed customers with financial services in 57 countries. The selection of products and services offered in each of these given markets is determined by HSBC's participation strategy in that market.

In markets where HSBC already has scale or, in the case of emerging markets where scale can be built over time, HSBC offers a full range of personal financial products and services. Typically, products provided include personal banking products (current and savings accounts, mortgages and personal loans, credit cards, and local and international payment services), together with consumer finance and wealth management services.

In other markets, HSBC participates more selectively, targeting only those customer segments which have strong international connectivity or where HSBC's global scale is crucial.

HSBC Premier is a comprehensive banking and wealth management service for mass affluent, internationally orientated customers. This premium banking service provides personalised relationship management, a single online view of all international accounts, free international funds transfer between HSBC accounts, 24-hour priority telephone access, global travel assistance and wealth management services. There are now over 2.1 million HSBC Premier customers, who can use more than 280 specially designated Premier branches and centres in 37 countries and territories, either temporarily when visiting or on a more permanent basis if they require a banking relationship in more than one country.

There are some markets where HSBC maintains a Personal Financial Services presence in order to enhance international connectivity for the customer, principally for HSBC Premier. These markets offer a more limited range of products and services.

In certain selected markets, HSBC Direct provides products specifically tailored for the online market.

Wealth management (insurance and investment products and financial planning services) plays an important part in meeting the needs of customers. Insurance products distributed by HSBC through its direct channels and branch networks include loan protection, life, property and health insurance and pensions. Acting as both broker and underwriter,

HSBC continues to see opportunities to provide insurance products to more of its customer base. HSBC also makes available a wide range of investment products. A choice of third party and proprietary funds is offered, including traditional "long only" equity and bond funds; structured funds that provide capital security and opportunities for an enhanced return; and "fund of funds" products which offer customers the ability to diversify their investments across a range of best-in-class fund managers chosen after a rigorous and objective selection process. Comprehensive financial planning services covering customers' investment, retirement, personal and asset protection needs are offered through qualified financial planning managers.



Delivering the right products and services for particular target markets is a fundamental requirement in any service business, and market research and customer analysis is essential to developing an in-depth understanding of significant customer segments and their needs. This understanding of the customer ensures that customer relationship management systems are effectively used to identify and fulfil sales opportunities, and to manage the sales process.

Personal customers prefer to conduct their financial business at times convenient to them, using the sales and service channels of their choice. This demand for flexibility is met through the increased provision of direct channels such as the internet and self-service terminals, in addition to traditional and automated branches and service centres accessed by telephone.

HSBC Finance's operations in the US, the UK and Canada make credit available to customers not well catered for by traditional banking operations, facilitate point-of-sale credit in support of retail purchases and support major affiliate credit card programmes.

HSBC Finance is a major credit card issuer in the US, offering HSBC, Household Bank, and Orchard bank branded cards together with affiliation programmes such as the GM Card and the AFL-CIO Union Plus card. HSBC Finance is also a major provider of third party private label credit cards (or store cards) through 56 merchant relationships.

High net worth individuals and their families who choose the differentiated services offered within Private Banking are not included in this customer group.

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Commercial Banking

HSBC is one of the world's leading and most international banks, with 2.8 million Commercial Banking customers in 64 locations, including sole proprietors, partnerships, clubs and associations, incorporated businesses and publicly quoted companies. At 31 December 2007, HSBC had total commercial customer account balances of US\$238 billion and total commercial customer loans and advances, net of loan impairment allowances, of US\$220 billion.

HSBC segments its Commercial Banking business into corporate, mid-market, small and micro businesses, allowing the development of tailored customer propositions while adopting a broader view of the entire Commercial Banking sector, from sole traders to top-end mid-market corporations. This allows HSBC to provide continuous support to companies as they grow in size both domestically and internationally, and ensures a clear focus on the small and micro business sectors, which are typically the key to innovation and growth in market economies.

HSBC places particular emphasis on geographical collaboration to meet its business customers' needs and aims to be recognised as the leading international business bank and the best bank for small business in target markets. The range of products and services includes:

**Financing:** HSBC provides a range of short and longer-term financing options for Commercial Banking customers, both domestically and cross-border, including overdrafts, receivables finance, term loans and property finance. The Group offers forms of asset finance in five sites and has established specialised divisions providing leasing and instalment finance for vehicles, plant and equipment.

**Payments and cash management:** HSBC is a leading provider of domestic and cross-border payments, collections, liquidity management and account services worldwide. The Group's extensive network of offices and direct access to numerous local clearing systems enhances its customers' ability to manage their cash efficiently on a global basis.

**International trade:** HSBC finances and facilitates significant volumes of international trade, under both open account terms and traditional trade finance instruments. HSBC also provides international factoring, commodity and insured export finance, and forfaiting services. The Group utilises its extensive international network to build customer relationships at both ends of trade flows,

and maximises efficiency through expertise in documentary checking and processing, and highly automated systems.

**Treasury and capital markets :** Commercial Banking customers are volume users of the Group's foreign exchange capabilities, including sophisticated currency and interest rate options.

**Commercial cards :** HSBC offers commercial card services in 39 countries. Commercial card issuing provides its customers with services which enhance cash management, improve cost control and streamline purchasing processes. HSBC offers card acquiring services, either directly or as part of a joint venture, enabling merchants to accept credit card payments either in store or on the internet.

**Insurance :** HSBC offers insurance services in 28 sites which cover a full range of commercial insurance products designed to meet the needs of businesses and their employees, including employee benefit, pension and healthcare programmes, and a variety of commercial risks such as buildings, marine, cargo, keyman and credit protection. These products are provided by HSBC either as an intermediary (broker, agent or consultant) or as a supplier of in-house or third party offerings. HSBC also provides insurance due diligence reviews, and actuarial and employee benefit consultancy services.

**Wealth management services :** These include advice and products related to savings and investments provided to Commercial Banking customers and their employees through HSBC's worldwide network, with clients being referred to Private Banking where appropriate.

**Investment banking** : A small number of Commercial Banking customers need corporate finance and advisory support. These requirements are serviced by the Group on a client-specific basis.

**Delivery channels** : HSBC deploys a full range of delivery channels, including specific online and direct banking offerings such as HSBCnet and Business Internet Banking.

#### Global Banking and Markets

Global Banking and Markets provides tailored financial solutions to major government, corporate and institutional clients worldwide. Managed as a global business, Global Banking and Markets operates a long-term relationship management approach to build a full understanding of clients' financial requirements. Sectoral client service teams comprising relationship managers and product specialists develop financial solutions to meet individual client needs. With dedicated offices in

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*Products and services / Property / Legal proceedings*

over 60 countries and access to HSBC's worldwide presence and capabilities, this business serves subsidiaries and offices of its clients on a global basis.

Global Banking and Markets is managed as four principal business lines: Global Markets, Global Banking, Principal Investments and HSBC Global Asset Management. This structure allows HSBC to focus on relationships and sectors that best fit the Group's footprint and facilitates seamless delivery of HSBC's products and services to clients.

### Global Markets

HSBC's operations in Global Markets consist of treasury and capital markets services for supranationals, central banks, corporations, institutional and private investors, financial institutions and other market participants. Products include:

- foreign exchange;
- currency, interest rate, bond, credit, equity and other specialised derivatives;
- government and non-government fixed income and money market instruments;
- precious metals and exchange traded futures;
- equity services, including research, sales and trading for institutional, corporate and private clients and asset management services;
- distribution of capital markets instruments, including debt, equity and structured products, utilising links with HSBC's global networks; and
- securities services, where HSBC is one of the world's leading custodians providing custody and clearing services and funds administration to both domestic and cross-border investors.

### Global Banking

HSBC's operations in Global Banking consist of financing, advisory and transaction services for corporations, institutional and private investors, financial institutions, and governments and their agencies. Products include:

- financing and capital markets, which comprises capital raising, including debt and equity capital, corporate finance and advisory services, bilateral and syndicated lending, leveraged and acquisition finance, structured and project finance, lease finance, and non-retail deposit-taking;
- international, regional and domestic payments and cash management services; and
- other transaction services, including trade services, factoring and banknotes.

### HSBC Global Asset Management

This offers asset management products and services for institutional investors, intermediaries and individual investors and their advisers.

## Other

Other products include private equity, which comprises HSBC's captive private equity funds, strategic relationships with third party private equity managers and other investments.

### Private Banking

HSBC's presence in all the major wealth-creating regions has enabled it to build one of the world's leading private banking groups, providing private banking and trustee services to high net worth individuals and their families from 90 locations in 37 countries and territories, with client assets of US\$421 billion at 31 December 2007.

HSBC Private Bank is the principal marketing name of the HSBC Group's international private banking business which, together with HSBC Guyerzeller and the private banking activities of HSBC Trinkaus & Burkhardt, provides the services noted below.

Utilising the most suitable products from the marketplace, Private Banking works with its clients to offer both traditional and innovative ways to manage and preserve wealth while optimising returns. Products and services offered include:

**Investment services** : These comprise both advisory and discretionary investment services. A wide range of investment vehicles is covered, including bonds, equities, derivatives, options, futures, structured products, mutual funds and alternative products, such as hedge funds and fund of funds. By accessing regional expertise located within six major advisory centres in Hong Kong, Singapore, Geneva, New York, Paris and London, Private Banking seeks to select the most suitable investments for clients' needs and investment strategies.

**Global wealth solutions** : These comprise inheritance planning, trustee and other fiduciary services designed to protect existing wealth and create tailored structures to preserve wealth for future generations. Areas of expertise include trusts,

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foundation and company administration, charitable trusts and foundations, insurance and offshore structures.

**Specialist advisory services:** Private Banking offers expertise in several specialist areas of wealth management including tax advisory and financial planning, family office advisory, corporate finance, consolidated reporting, industry services such as charities and foundations, media, shipping, diamonds and jewellery, and real estate planning. Specialist advisers are available to deliver products and services that are tailored to meet the full range of high net worth clients' individual financial needs.

**General banking services:** These comprise treasury and foreign exchange, offshore and onshore deposits, credit and specialised lending, tailor-made loans and internet banking. Private Banking works to ensure its clients have full access to relevant skills and products available throughout HSBC, such as corporate banking, investment banking and insurance.

## Property

At 31 December 2007, HSBC operated from some 10,500 operational properties worldwide, of which approximately 3,300 were located in Europe, 850 in Hong Kong and Rest of Asia-Pacific, 1,850 in North America and 4,500 in Latin America. These properties had an area of approximately 69.8 million square feet (2006: 65.4 million square feet). Freehold, long leasehold and short leasehold land and buildings carried on the balance sheet represented 35 per cent of HSBC's operational space. In addition, properties with a net book value of US\$1,346 million were held for investment purposes. Of the total net book value of HSBC properties, more than 73 per cent were owned or held under long-term leases.

HSBC's operational properties are stated at cost, being historical cost or fair value at the date of transition to IFRSs (their deemed cost) less any impairment losses, and are depreciated on a basis calculated to write off the assets over their estimated useful lives. Properties owned as a consequence of an acquisition are recognised initially at fair value.

### Valuation of freehold and leasehold land and buildings

HSBC's freehold and long leasehold properties, together with all leasehold properties in Hong Kong, were valued in 2007. The value of these properties was US\$2.2 billion in excess of their carrying amount in the consolidated balance sheet.

Further details are included in Note 23 on the Financial Statements.

## Legal proceedings

HSBC is party to legal actions in a number of jurisdictions including the UK, Hong Kong and the US, arising out of its normal business operations. HSBC considers that none of the actions is material, and none is expected to result in a significant adverse effect on the financial position of HSBC, either individually or in the aggregate. Management believes that adequate provisions have been made in respect of such litigation. HSBC has not disclosed any contingent liability associated with these legal actions because it is not practicable to do so, except as disclosed below.

On 27 July 2007, the UK Office of Fair Trading (OFT) issued High Court legal proceedings against a number of UK financial institutions, including HSBC Bank plc, to determine the legal status and enforceability of certain of the charges applied to their personal customers in relation to unauthorised overdrafts (the 'charges'). Certain preliminary issues in these proceedings were heard in a trial in the Commercial Division of the High Court on 17 January 2008. This trial concluded on 8 February 2008 and judgment, on the preliminary issues tested, is awaited.

The proceedings remain at a very early stage and may, if appeals on the preliminary issues (or, subsequently, on substantive issues) are pursued, take a number of years to conclude. A wide range of outcomes is possible, depending, initially, upon whether the Court finds that some, all, or none of the charges should be tested for fairness and/or tested as common law penalties and, if it does find that some or all of the charges should be so tested, upon the Court's subsequent assessment of each charge across the period under review. Since July 2001,

there have been a variety of charges applied by HSBC Bank plc across different charging periods under the then current contractual arrangements. HSBC Bank plc considers the charges to be and to have been valid and enforceable, and intends strongly to defend its position.

If, contrary to HSBC Bank plc's current assessment, the Court should ultimately (after appeals) reach a decision adverse to HSBC Bank plc that results in liability for it, a large number of different outcomes is possible, each of which would have a different financial impact. Based on the facts currently available to it, and a number of assumptions, HSBC Bank plc estimates that the financial impact could be approximately

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US\$600 million. To make an estimate of the potential financial impact at this stage with any precision is extremely difficult, owing to (among other things) the complexity of the issues, the

number of permutations of possible outcomes, and the early stage of the proceedings. In addition, the assumptions made by HSBC Bank plc may prove to be incorrect.

### Footnotes to the Business Review

The footnotes below refer to the reconciliations of reported and underlying profit before tax, and the analyses of customer groups and global businesses on pages 16 to 35 and the geographical regions on pages 36 to 125.

- 1 *[Currency translation] is the effect of translating the results of subsidiaries and associates for the previous year at the average rates of exchange applicable in the current year.*
- 2 *[Acquisitions, disposals and (in 2007) dilution gains] comprises the net increment or decrement in profits in the current year (compared with the previous year) which is attributable to acquisitions or disposals made, or dilution gains, in the current year.*
- 3 *[Other income] in this context comprises net trading income (see 5 below), net income from financial instruments designated at fair value, gains less losses from financial investments, gains arising from dilution of interests in associates, dividend income, net earned insurance premiums and other operating income less net insurance claims incurred and movement in liabilities to policyholders.*
- 4 *Net operating income before loan impairment charges and other credit risk provisions.*
- 5 *In the analyses of customer groups and global businesses, net trading income comprises all gains and losses from changes in the fair value of financial assets and financial liabilities classified as held for trading, together with related external and internal interest income and interest expense, and dividends received; in the statutory presentation internal interest income and expense are eliminated .*
- 6 *Net insurance claims incurred and movement in liabilities to policyholders.*
- 7 *Third party only.*
- 8 *The main items reported under [Other] are certain property activities, unallocated investment activities including hsbc.com, centrally held investment companies, movements in the fair value of own debt designated at fair value, and HSBC's holding company and financing operations. The results include net interest earned on free capital held centrally and operating costs incurred by the head office operations in providing stewardship and central management services to HSBC. [Other] also includes the costs incurred by the Group Service Centres and Shared Service Organisations and associated recoveries.*



- 9 *The comparatives have been restated to reflect the current management view.*
- 10 *[Equities] includes a total gain of US\$107 million from the disposal of HSBC's investments in Euronext N.V. and the Montreal Exchange for 2007.*
- 11 *HSBC Global Asset Management was formerly known as Group Investment Businesses.*
- 12 *[Other] in Global Banking and Markets includes net interest earned on free capital held in the global business not assigned to products.*
- 13 *The results of Global Banking and Markets in Europe include gains from principal investments of US\$991 million (2006: US\$457 million; 2005: US\$610 million).*
- 14 *Inter-segment elimination comprises (i) the costs of shared services and Group Service Centres included within [Other] which are recovered from customer groups, and (ii) the intra-segment funding costs of trading activities undertaken within Global Banking and Markets. HSBC's balance sheet management business, reported within Global Banking and Markets, provides funding to the trading businesses. To report Global Banking and Markets' [Net trading income] on a fully funded basis, [Net interest income] and [Net interest income/(expense) on trading activities] are grossed up to reflect internal funding transactions prior to their elimination in the inter-segment column.*
- 15 *France primarily comprises the domestic operations of HSBC France and the Paris branch of HSBC Bank.*
- 16 *Trading assets, financial instruments designated at fair value, and financial investments held in Europe, and by Global Banking and Markets in North America, include financial assets which may be repledged or resold by counterparties.*

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The consolidated financial statements of HSBC and the separate financial statements of HSBC Holdings have been prepared in accordance with International Financial Reporting Standards (IFRSs) as endorsed by the European Union (EU). EU-endorsed IFRSs may differ temporarily from IFRSs as published by the International Accounting Standards Board (IASB) if, at any point in time, new or amended IFRSs have not been endorsed by the EU. At 31 December 2007, there were no unendorsed standards effective for the year ended 31 December 2007 affecting these consolidated and separate financial statements, and there was no difference between IFRSs endorsed by the EU and IFRSs issued by the IASB in terms of their application to HSBC. Accordingly, HSBC's financial statements for the year ended 31 December 2007 are prepared in accordance with IFRSs as issued by the IASB.

Certain information for 2003 has been prepared under UK Generally Accepted Accounting Principles (UK GAAP), which are not comparable with IFRSs.

HSBC uses the US dollar as its presentation currency because the US dollar and currencies linked to it form the major currency bloc in which HSBC transacts its business. Unless otherwise stated, the accounting information presented in this document has been prepared in accordance with IFRSs.

Constant currency

Constant currency comparatives for 2006 and 2005 used in the 2007 and 2006 commentaries, respectively, are computed by retranslating into US dollars, for non-US dollar branches, subsidiaries, joint ventures and associates:

- the income statements for 2006 and 2005 at the average rates of exchange for 2007 and 2006, respectively; and
- the balance sheets at 31 December 2006 and 2005 at the prevailing rates of exchange on 31 December 2007 and 2006, respectively.

No adjustment has been made to the exchange rates used to translate foreign currency denominated assets and liabilities into the functional currencies of any HSBC branches, subsidiaries, joint ventures or associates. When reference is made to "constant currency" in tables or commentaries, comparative data reported in the functional currencies of HSBC's operations have been translated at the appropriate exchange rates applied in the current period on the basis described above.

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HSBC HOLDINGS PLC

## Report of the Directors: Financial Review

(continued)

*Critical accounting policies*

### Critical accounting policies

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*(Audited)*

#### Introduction

The results of HSBC are sensitive to the accounting policies, assumptions and estimates that underlie the preparation of its consolidated financial statements. The accounting policies used in the preparation of the consolidated financial statements are described in Note 2 on the Financial Statements.

When preparing the financial statements, it is the directors' responsibility under UK company law to select suitable accounting policies and to make judgements and estimates that are reasonable and prudent.

The accounting policies that are deemed critical to HSBC's IFRSs results and financial position, in terms of the materiality of the items to which the policy is applied, and which involve a high degree of judgement including the use of assumptions and estimation, are discussed below.

#### Impairment of loans and advances

HSBC's accounting policy for losses arising from the impairment of customer loans and advances is described in Note 2f on the Financial Statements. Loan impairment allowances represent management's best estimate of losses incurred in the loan portfolios at balance sheet date.

Management is required to exercise judgement in making assumptions and estimations when calculating loan impairment allowances on both individually and collectively assessed loans and advances. Of the Group's total loans and advances to customers before impairment allowances of US\$1,000.8 billion (2006: US\$881.7 billion), US\$6.5 billion (2006: US\$5.8 billion) or 1 per cent (2006: 1 per cent) were individually assessed for impairment, and US\$994.3 billion (2006: US\$875.9 billion) or 99 per cent (2006: 99 per cent) were collectively assessed for impairment.

The most significant judgemental area is the calculation of collective impairment allowances. HSBC's most significant geographical area of exposure to collectively assessed loans and advances is North America, which comprised US\$301.4 billion (2006: US\$284.8 billion) or 30 per cent (2006: 33 per cent) of HSBC's total collectively assessed loans and advances. Collective impairment allowances in North America were US\$11.9 billion (2006: US\$7.1 billion), representing 72 per cent (2006: 65 per cent) of the total collectively assessed loan impairment allowance.

HSBC uses two alternative methods to calculate collective impairment allowances on homogeneous groups of loans that are not considered individually significant:

- When appropriate empirical information is available, HSBC utilises roll-rate methodology.

This methodology employs statistical analysis of historical data and experience of delinquency and default to estimate the likelihood that loans will progress through the various stages of delinquency and ultimately prove irrecoverable. The estimated loss is the difference between the present value of expected future cash flows, discounted at the original effective interest rate of the portfolio, and the carrying amount of the portfolio.

- In other cases, when the portfolio size is small or when information is insufficient or not reliable enough to adopt a roll-rate methodology, HSBC adopts a formulaic approach which allocates progressively higher percentage loss rates the longer a customer's loan is overdue. Loss rates are based on historical experience. Both methodologies are subject to estimation uncertainty, in part because it is not practicable to identify losses on an individual loan basis because of the large number of individually insignificant loans in the portfolio.

In addition, the use of statistically assessed historical information is supplemented with significant management judgement to assess whether current economic and credit conditions are such that the actual level of inherent losses is likely to be greater or less than that suggested by historical experience. In normal circumstances, historical experience provides the most objective and relevant information from which to assess inherent loss within each portfolio. In certain circumstances, historical loss experience provides less relevant information about the inherent loss in a given portfolio at the balance sheet date, for example, where there have been changes in economic, regulatory or behavioural conditions such that the most recent trends in the portfolio risk factors are not fully reflected in the statistical models. In these circumstances, such risk factors are taken into account when calculating the appropriate levels of impairment allowances, by adjusting the impairment allowances derived solely from historical loss experience.

This key area of judgement is subject to uncertainty and is highly sensitive to factors such as loan portfolio growth, product mix, unemployment

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rates, bankruptcy trends, geographic concentrations, loan product features, economic conditions such as national and local trends in housing markets, the level of interest rates, portfolio seasoning, account management policies and practices, changes in laws and regulations, and other factors that can affect customer payment patterns. Different factors are applied in different regions and countries to reflect different economic conditions and laws and regulations. The assumptions underlying this judgement are highly subjective. The methodology and the assumptions used in calculating impairment losses are reviewed regularly in the light of differences between loss estimates and actual loss experience. For example, roll rates, loss rates and the expected timing of future recoveries are regularly benchmarked against actual outcomes to ensure they remain appropriate.

The total amount of the Group's impairment allowances on homogeneous groups of loans is inherently uncertain because it is highly sensitive to changes in economic and credit conditions across a large number of geographical areas. Economic and credit conditions within geographical areas are influenced by many factors with a high degree of interdependency so that there is no one single factor to which the Group's loan impairment allowances as a whole are particularly sensitive. However, HSBC's loan impairment allowances are particularly sensitive to general economic and credit conditions in North America. For example, a 10 per cent increase in impairment allowances on collectively assessed loans and advances in North America would increase loan impairment allowances by US\$1.2 billion at 31 December 2007 (2006: US\$714 million). It is possible that the outcomes within the next financial year could be different from the assumptions built into the models, resulting in a material adjustment to the carrying amount of loans and advances.

#### Goodwill impairment

HSBC's accounting policy for goodwill is described in Note 2o on the Financial Statements. Note 22 on the Financial Statements sets out the Group's cash generating units ("CGUs") by geographical region and global business. The most significant amount of goodwill relates to the Personal Financial Services - North America CGU, which amounts to US\$10.2 billion or 30 per cent of total goodwill. The process of identifying and evaluating goodwill impairment is inherently uncertain because it requires significant management judgement in making a series of estimations, the results of which are highly sensitive to the assumptions used. The

review of goodwill impairment represents management's best estimate of the factors below.

Firstly, significant management judgement is required in estimating the future cash flows of the CGUs. These values are sensitive to the cash flows projected for the periods for which detailed forecasts are available, and to assumptions regarding the long-term pattern of sustainable cash flows thereafter. Forecasts are compared with actual performance and verifiable economic data in future years; however, the cash flow forecasts necessarily and appropriately reflect management's view of future business prospects. Note 22 shows how the key assumptions used in estimating future cash flows for each CGU have changed from 2006 to 2007.

Secondly, the cost of capital assigned to an individual CGU and used to discount its future cash flows can have a significant effect on the CGU's valuation. The cost of capital percentage is generally derived from a Capital Asset Pricing Model, which incorporates inputs reflecting a number of financial and economic variables, including the risk-free interest rate in the country concerned and a premium to reflect the inherent risk of the business being evaluated. These variables are established on the basis of significant management judgement and are subject to uncertainty.

When this exercise demonstrates that the expected cash flows of a CGU have declined and/or that its cost of capital has increased, the effect is to reduce the CGU's estimated fair value. If this results in an estimated recoverable amount that is lower than the carrying value of the CGU, a charge for impairment of goodwill will be recorded, thereby reducing by a corresponding amount HSBC's profit for the year.

Note 22 on the Financial Statements includes details of the CGUs with significant balances of goodwill, and states the key assumptions used to assess the goodwill in each CGU for impairment.

Goodwill impairment testing performed in 2007 and 2006 indicated that there was no impairment of goodwill. It is possible that the outcomes within the next financial year could be different from the assumptions used, resulting in a material adjustment to the carrying amount of goodwill. In particular, the deterioration in the economic and credit conditions in North America has resulted in a severe decline in the profitability of the North American consumer finance business during 2007, and as a result goodwill impairment in the Personal Financial

Services □ North America CGU was re-tested as at 31 December 2007. Notwithstanding these conditions, the recoverable amount based on

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HSBC HOLDINGS PLC

## Report of the Directors: Financial Review

(continued)

*Critical accounting policies > Financial summary / Income statement*

expected cash flows continued to exceed the carrying amount including goodwill in the CGU, and therefore no goodwill impairment has occurred. However, in the event of further significant deterioration in the economic and credit conditions beyond the levels already reflected by management in the cash flow forecasts for the CGU, a further special review would be made, in addition to the annual review of the carrying value, including goodwill against the recoverable amount for the CGU. If this review indicated that the deterioration in current conditions and future outlook is sufficiently severe, this could result in a material adjustment to the carrying amount of goodwill.

### Valuation of financial instruments

HSBC's accounting policy for valuation of financial instruments is described in Note 2d on the Financial Statements.

The best evidence of fair value is a quoted price in an actively traded market. If the market for a financial instrument is not active, a valuation technique is used. The majority of valuation techniques employ only observable market data, and so the reliability of the fair value measurement is high. However, certain financial instruments are valued on the basis of valuation techniques that feature one or more significant market inputs that are not observable. Valuation techniques that rely to a greater extent on non-observable inputs require a higher level of management judgement to calculate a fair value than those based wholly on observable inputs.

Valuation techniques used to calculate fair values include comparisons with similar financial instruments for which market observable prices exist, discounted cash flow analysis, option pricing models and other valuation techniques commonly used by market participants. Valuation techniques incorporate assumptions that other market participants would use in their valuations, including assumptions about interest rate yield curves, exchange rates, volatilities, and prepayment and default rates. When valuing instruments by reference to comparable instruments, management takes into account the maturity, structure and rating of the instrument with which the position held is being compared.

The main assumptions and estimates which management considers when applying a model with valuation techniques are:

- the likelihood and expected timing of future cash flows on the instrument. These cash flows are usually governed by the terms of the instrument, although management judgement may be required when the ability of the counterparty to service the instrument in accordance with the contractual terms is in doubt. Future cash flows may be sensitive to changes in market rates;
- selecting an appropriate discount rate for the instrument. Management bases the determination of this rate on its assessment of what a market participant would regard as the appropriate spread of the rate for the instrument over the appropriate risk-free rate; and
- judgement to determine what model to use to calculate fair value in areas where the choice of valuation model is particularly subjective, for example, when valuing complex derivative products.



When applying a model with unobservable inputs, estimates are made to reflect uncertainties in fair values resulting from a lack of market data inputs, for example, as a result of illiquidity in the market. For these instruments, the fair value measurement is less reliable. Inputs into valuations based on non-observable data are inherently uncertain because there are little or no current market data available from which to determine the level at which an arm's length transaction would occur under normal business conditions. However, in most cases there are some market data available on which to base a determination of fair value, for example historical data, and the fair values of most financial instruments will be based on some market observable inputs even where the non-observable inputs are significant.

Note 33 on the Financial Statements provides an analysis of the basis for valuation of financial instruments measured at fair value in the financial statements. The value of financial assets and liabilities that use a valuation technique are US\$625.5 billion and US\$400.7 billion or 66 per cent and 68 per cent of total assets and total liabilities measured at fair value respectively. Note 33 on the Financial Statements presents a sensitivity analysis of fair values for financial instruments with significant unobservable inputs to reasonably possible alternative assumptions. Given the uncertainty and subjective nature of valuing financial instruments at fair value, it is possible that the outcomes within the next financial year could be different from the assumptions used, and this would result in a material adjustment to the carrying amount of financial instruments measured at fair value.

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## Income statement

	Year ended 31 December		
	2007 US\$m	2006 US\$m	2005 US\$m
Interest income	92,359	75,879	60,094
Interest expense	(54,564)	(41,393)	(28,760)
Net interest income	37,795	34,486	31,334
Fee income	26,337	21,080	17,486
Fee expense	(4,335)	(3,898)	(3,030)
Net fee income	22,002	17,182	14,456
Trading income excluding net interest income	4,458	5,619	3,656
Net interest income on trading activities	5,376	2,603	2,208
Net trading income	9,834	8,222	5,864
Net income from financial instruments designated at fair value	4,083	657	1,034
Gains less losses from financial investments	1,956	969	692
Gains arising from dilution of interests in associates	1,092	□	□
Dividend income	324	340	155
Net earned insurance premiums	9,076	5,668	5,436
Other operating income	1,439	2,546	2,733
<b>Total operating income</b>	<b>87,601</b>	<b>70,070</b>	<b>61,704</b>
Net insurance claims incurred and movement in liabilities to policyholders .	(8,608)	(4,704)	(4,067)
<b>Net operating income before loan impairment charges and other credit risk provisions</b>	<b>78,993</b>	<b>65,366</b>	<b>57,637</b>
Loan impairment charges and other credit risk provisions	(17,242)	(10,573)	(7,801)
<b>Net operating income</b>	<b>61,751</b>	<b>54,793</b>	<b>49,836</b>
Employee compensation and benefits	(21,334)	(18,500)	(16,145)
General and administrative expenses	(15,294)	(12,823)	(11,183)
Depreciation of property, plant and equipment	(1,714)	(1,514)	(1,632)
Amortisation and impairment of intangible assets	(700)	(716)	(554)
<b>Total operating expenses</b>	<b>(39,042)</b>	<b>(33,553)</b>	<b>(29,514)</b>
<b>Operating profit</b>	<b>22,709</b>	<b>21,240</b>	<b>20,322</b>
Share of profit in associates and joint ventures	1,503	846	644
<b>Profit before tax</b>	<b>24,212</b>	<b>22,086</b>	<b>20,966</b>
Tax expense	(3,757)	(5,215)	(5,093)
<b>Profit for the year</b>	<b>20,455</b>	<b>16,871</b>	<b>15,873</b>

Profit attributable to shareholders of the parent company	<b>19,133</b>	15,789	15,081
Profit attributable to minority interests	<b>1,322</b>	1,082	792

Year ended 31 December 2007 compared with year ended 31 December 2006

The strength of HSBC's diversified business model was demonstrated by profit growth in a year in which financial markets experienced significant dislocation and the credit environment, particularly in the US, deteriorated markedly. Pre-tax profits in 2007 increased by 10 per cent to US\$24.2 billion and earnings per share rose by 18 per cent to US\$1.65. Despite unprecedented market conditions, the return on shareholders' equity exceeded 15 per

cent, capital ratios remained strong, revenue growth was in double digits and the cost efficiency ratio improved. For the first time in recent years, pre-tax profits from the Group's emerging markets operations exceeded 60 per cent of total profits.

On an underlying basis, profit before tax was broadly in line with 2006. This was arrived at after excluding the effects of a US\$1.1 billion gain from the dilution of holdings in associates in mainland China, restating comparative information using the average exchange rates applicable in 2007, and

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HSBC HOLDINGS PLC

## Report of the Directors: Financial Review

(continued)

### *Income statement*

adjusting for acquisitions and disposals. The table on page 15 provides a more detailed reconciliation of reported and underlying profit before tax.

These results illustrated the benefit derived from the Group's broad diversification, both geographically and by range of business. An excellent performance in Asia in all customer groups compensated for the effect of deteriorating conditions in the US and slower growth in other mature markets. Commercial Banking and Private Banking again delivered record results, as did many of the businesses within the newly designated Global Banking and Markets segment.

In Asia, the Group had a notably strong year. Vigorous economic activity across the region, strong trade flows and buoyant equity markets helped drive underlying profit growth of 42 per cent in Hong Kong and 34 per cent in Rest of Asia-Pacific. This growth was broadly based, with profits in all customer groups and in each of the main countries in which HSBC operates ahead of 2006. Results in Latin America were also better than in 2006, as an excellent performance in Brazil more than offset higher loan impairment charges in Mexico.

Pre-tax profits in North America fell significantly as loan impairment charges rose and trading income declined. What began in 2006 as a deterioration in credit quality in a particular portfolio of purchased mortgages in the US consumer finance business, widened in the second half of 2007 to affect the consumer lending business as a whole as economic conditions deteriorated in the US, the housing market contracted and market liquidity for asset-backed securities dried up. This lack of liquidity also adversely affected credit trading and asset-backed securities businesses within Global Banking and Markets where de-leveraging of traded markets contributed to volatility and lower valuations. The effect of these factors was partially offset by a gain on HSBC's own debt designated at fair value.

Within Europe, underlying pre-tax profit performance was mixed, mainly as a consequence of ex gratia payments expensed in respect of overdraft fees applied in previous years and a provision for reimbursement of certain charges on historic will trusts and other related services. Offsetting this was a large fair value gain on the valuation of the portion of the Group's own debt that is carried at fair value. Encouragingly, Personal Financial Services in the UK proved very successful in attracting deposit balances, which rose 15 per cent on 2006.

In 2007, notwithstanding the severe disruption in traded markets, Global Banking and Markets delivered higher profits, which rose by 5 per cent to US\$6.1 billion. This was driven by record results in its foreign exchange, payments and cash management, equities, HSBC Global Asset Management and securities services businesses; these more than offset the significant write-downs in the Credit and Rates businesses, largely the consequence of the market-related factors discussed above.

Year ended 31 December 2006 compared with year ended 31 December 2005

HSBC made a profit before tax of US\$22.1 billion, a rise of US\$1.1 billion, or 5 per cent, compared with 2005. Incremental contributions to pre-tax profit from Metris in the US, the Argentine retail operations acquired from Banca Nazionale and Ping An Insurance in mainland China, less the profits of Cyprus Popular Bank, which was sold during the year, accounted for US\$347 million of the increase in pre-tax profit in the period. These represented the bulk of changes in the constitution of the Group. On an underlying basis, which is described on page 131, profit before tax increased by 3 per cent.

Average invested capital increased by US\$10.6 billion compared with 2005 and return on that capital fell slightly by 1.0 per cent to 14.9 per cent. Revenue growth was 13 per cent and the cost efficiency ratio was broadly unchanged at 51.3 per cent; the Group's Tier 1 ratio strengthened to 9.4 per cent.

HSBC's results in 2006 reflected the benefits of diversified earnings. There were a number of outstanding achievements, for example, exceeding US\$1 billion pre-tax profits for the first time in Mexico and the Middle East, and in each of the Group Private Banking and Commercial Banking businesses in Rest of Asia-Pacific. HSBC added approximately US\$1 billion in extra pre-tax profits in Rest of Asia-Pacific and globally in the Commercial Banking businesses.

However, results in 2006 also reflected a decline in pre-tax profits of around US\$725 million in the Group's personal businesses in the US as a portfolio of sub-prime mortgages purchased by a subsidiary of HSBC Finance, mortgage services, suffered much higher delinquency than had been built into pricing these products.

Earnings continued to be well diversified, both geographically and by customer group. Regionally, Asia including Hong Kong had record results as did the Group's newly designated Latin America region, which combines Mexico and Central America with HSBC's South American businesses. Within the

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Customer Groups, Commercial Banking again delivered a record performance, as did Private Banking and Global Banking and Markets, which made strong progress in the areas in which the Group has been investing in recent years. Personal Financial Services declined as growth in Asia and Latin America was masked by the problems in the US mortgage services business.

The economic backdrop in 2006 was favourable. Global equity markets enjoyed strong gains for much of the year, encouraging expanded investment flows and creating a receptive marketplace for the high level of mergers and acquisitions and IPO activity which followed. However, in these favourable conditions, the cumulative effect of rising short-term rates, benign credit conditions and strong liquidity put pressure on interest margins.

The credit environment for corporate and commercial lending continued to be exceptionally good. However, on the back of slowing housing markets and rising interest rates, a marked deterioration was experienced in the sub-prime mortgage market in the US. This more than outweighed the non-recurrence in 2006 of loan impairment costs associated with a surge in bankruptcy filings in the US in the fourth quarter of 2005, and the effect of hurricane Katrina.

Net operating income before loan impairment charges and other credit risk provisions of US\$65.4 billion was US\$7.7 billion or 13 per cent higher than in 2005, 11 per cent higher on an underlying basis. Commercial Banking, Global Banking and Markets and Private Banking operations all achieved strong double-digit growth. Operating income performance was well spread geographically, with the strongest growth in HSBC's operations in Asia and in Latin America.

Loan impairment and other credit risk provisions, expressed as a percentage of gross average advances to customers, at 1.4 per cent, were 20 basis points higher in 2006 than the 1.2 per cent recorded in 2005. There was also a 20 basis point

rise in the ratio of new loan impairment charges to gross average advances to customers, from 1.4 per cent in 2005 to 1.6 per cent in 2006. The charge of US\$10.6 billion was US\$2.8 billion, or 36 per cent, higher than in 2005, 30 per cent higher on an underlying basis. Of this increase, approximately 60 per cent arose in the Group's Personal Financial Services businesses in North America, with the major increase being in the US sub-prime mortgage portfolio acquired through mortgage services. Impairment charges in the UK were broadly stable as a percentage of lending to customers despite a rising trend of consumer recourse to debt mitigation arrangements. There was also some credit deterioration in a few emerging market countries, notably in the first half of 2006, as a consequence of regulatory changes.

Total operating expenses of US\$33.6 billion were US\$4.0 billion or 14 per cent higher than in 2005, 11 per cent higher on an underlying basis. Much of the growth reflected investment to expand the Group's geographic presence and add product expertise and sales support. This expansion was most marked in Personal Financial Services in North America, and in Global Banking and Markets, where the cost efficiency ratio improved slightly as strong revenue growth offset the first full year effect of investment expenditure in previous years.

HSBC's share of profit in associates and joint ventures increased by US\$202 million, with improved contributions from The Saudi British Bank, Bank of Communications and Industrial Bank, supplemented by a first full year contribution from Ping An Insurance. HSBC's share of profits from investments in associates in Rest of Asia-Pacific accounted for nearly a quarter of the profits from that region. For further detailed discussion and analysis by geographical segment of the Group's results see Report of the Directors: Business Review from page 76.

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HSBC HOLDINGS PLC

**Report of the Directors: Financial Review**

(continued)

Net interest income

**Net interest income**

	Year ended 31 December					
	2007		2006		2005	
	US\$m	%	US\$m	%	US\$m	%
<b>By geographical region</b>						
Europe	7,746	20.4	8,289	24.0	8,221	26.2
Hong Kong	5,483	14.5	4,685	13.6	4,064	13.0
Rest of Asia-Pacific	4,143	11.0	3,047	8.8	2,412	7.7
North America	14,847	39.3	14,268	41.4	13,295	42.4
Latin America	5,576	14.8	4,197	12.2	3,342	10.7
Net interest income	<b>37,795</b>	<b>100.0</b>	34,486	100.0	31,334	100.0

	Year ended 31 December		
	2007	2006	2005
Net interest income (US\$m)	37,795	34,486	31,334
Average interest-earning assets (US\$m)	1,296,701	1,113,404	999,421
Gross interest yield (per cent) <sup>1</sup>	7.12	6.82	6.01
Net interest spread (per cent) <sup>2</sup>	2.86	2.94	2.88
Net interest margin (per cent) <sup>3</sup>	2.91	3.10	3.14

1 Gross interest yield is the average annualised interest rate earned on average interest-earning assets (□AIEA□).

2 Net interest spread is the difference between the average annualised interest rate earned on AIEA, net of amortised premiums and loan fees, and the average annualised interest rate paid on average interest-bearing funds.

3 Net interest margin is net interest income expressed as an annualised percentage of AIEA.

Year ended 31 December 2007 compared with year ended 31 December 2006

Net interest income of US\$37.8 billion increased by 10 per cent, 4 per cent on an underlying basis. The commentary below is on an underlying basis.

The change in net interest income was influenced by the following factors:

- higher average interest rates in many major currencies resulted in higher interest income from the investment of low-cost deposits and transactional balances in Personal Financial Services and the payments and cash management businesses within Commercial Banking and Global Banking and Markets;
- lending spreads in 2007 continued to reflect the relatively benign corporate and commercial credit conditions which have existed for the past three to four years, some upward re-pricing occurred in personal lending as a result of growing delinquency and restricted credit appetite. As market liquidity was withdrawn in the last four months of the year, the value and cost of funding rose markedly;
- HSBC continued to focus on competitive liability products, which led to a 16 per cent growth in average deposits and current accounts; this exceeded the 6 per cent rise in average loans and advances to customers;
- there was an increased cost of funding HSBC's trading activities in HSBC's overall result. Net interest income includes the cost of funding

trading assets, while the related external revenues are reported in trading income. In HSBC's customer group results, the cost of funding trading assets is included within Global Banking and Markets' net trading income as an interest expense; and

- balance sheet management revenues increased compared with 2006. This was mainly due to recovery in Asia.

In **Europe**, net interest income declined by 18 per cent. This was mainly driven by the expansion of trading activities in both the UK and France which resulted in higher funding costs, with the related revenues reported in the trading income line, as discussed above. This was partly offset by higher net interest income in the personal and commercial businesses.

In the UK, Personal Financial Services' spreads widened in a rising interest rate environment and competitive pricing attracted higher balances. This was mitigated by lower spreads on mortgages as customers switched to fixed rate products. In Commercial Banking, higher net interest income was largely driven by growth in the UK, Turkey, Germany and Malta. The launch of a negotiated rate deposit product in previous years continued to prove successful in driving higher deposit balances. Strong growth in corporate and structured banking for micro customers, together with expansion in lending to small and mid-market customers, contributed to higher lending balances in the UK, although this



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benefit was partially constrained by spread compression in a competitive market.

Revenues from transactional balances held within the payments and cash management business increased by 13 per cent, as credit market dislocation in the second half of the year caused customers to hold higher cash balances. After several periods of decline, balance sheet management revenues in Europe increased.

In Turkey, higher net interest income was driven by new customer acquisition. In Switzerland, the Private Banking business earned higher net interest income from lending to existing clients as they further leveraged their portfolios.

In **Hong Kong**, net interest income rose by 17 per cent, driven by growth in asset and liability products in the personal, commercial and corporate businesses. Net interest income from Global Banking and Markets increased by 79 per cent as balance sheet management revenues recovered and deposits grew strongly with higher spreads. A rise in liabilities to fund trading activities reduced net interest income, with a corresponding rise in trading income.

Personal Financial Services' net interest income grew by 16 per cent, driven by wider spreads on higher deposit balances. The relaunch of HSBC Premier contributed to the growth in deposit balances. Card balances were also higher, following a number of promotional programmes during the year. In Commercial Banking, strong economic growth helped generate demand for savings products and this, combined with strong customer acquisition, resulted in higher net interest earned from liability products.

In **Rest of Asia-Pacific**, HSBC continued to invest in expanding the branch network, particularly in the large markets of mainland China, Indonesia and India. This, combined with increased marketing and greater brand awareness, accelerated customer acquisition and consequently growth in loans and deposits. Net interest income across the region rose by 30 per cent.

In the Middle East, net interest income increased significantly, driven by balance sheet expansion across all customer groups, augmented by improved yields. Balance sheet growth was underpinned by a strong local economy, higher oil prices and demand for credit for infrastructure investment.

In Global Banking and Markets, higher net interest income was driven by the recovery in balance sheet management revenues. As trade and

investment flows increased, higher transactional balances in the payments and cash management businesses also delivered higher net interest income.

In Personal Financial Services, net interest income rose by 23 per cent, driven by higher personal lending, credit cards and deposit balances. Growth was broad-based across the region. Commercial Banking net interest income grew by 29 per cent. Expansion of the branch network, call centres and Business Internet Banking helped to drive an increase in customer numbers which, in turn, led to deposit and loan growth.

Net interest income in **North America** rose by 4 per cent, as higher revenues from payments and cash management, commercial lending and cards were offset by lower mortgage balances, spread compression and higher non-performing balances.

Overall average lending balances were 5 per cent higher, as growth in credit cards and vehicle finance offset lower mortgage balances. The benefits of higher volumes were largely offset as asset spreads narrowed due to higher funding costs. Also, although deposit balances rose, spreads reduced as the product mix shifted to higher yielding products. Business expansion and higher customer volumes drove growth in loans and deposits in Commercial Banking. A 43 per cent increase in revenue from payments and cash management was due to higher customer balances.

In **Latin America**, net interest income increased by 17 per cent. Growth was strong across the region, with net interest income rising by 22 and 11 per cent in Mexico and Brazil, respectively.

In Mexico, notwithstanding lower balance sheet management revenues, higher net interest income was due to both asset and liability growth. In particular, increased credit card balances were driven by marketing and portfolio management initiatives to improve customer retention and card usage. Net interest income in Brazil increased as the sound economic outlook and falling interest rates resulted in strong demand for credit.

Average interest-earning assets (AIEA) of US\$1,297 billion were US\$121 billion, or 10 per cent, higher than 2006 on an underlying basis.

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HSBC HOLDINGS PLC

## Report of the Directors: Financial Review

(continued)

*Net interest income / Net fee income*

Year ended 31 December 2006 compared with year ended 31 December 2005

Net interest income of US\$34.5 billion was 10 per cent higher than in 2005 and 7 per cent higher on an underlying basis. The commentary that follows is on an underlying basis.

Movements in net interest income were particularly influenced by the following factors:

- rising short-term interest rates in US dollars and linked currencies, and in sterling, increased the value of low-cost deposits and transactional balances and increased the interest income earned from investing those balances. This was particularly relevant to the Personal Financial Services and Commercial Banking businesses in Asia and the UK, and also improved the value of cash balances within the Group's custody and payments and cash management businesses and increased the resultant investment income;
- the cumulative effect of higher short-term interest rates in most major currencies in recent years has been to flatten interest rate yield curves and to reduce the opportunities available to HSBC's balance sheet management operations to generate additional income. This reduced growth in net interest income compared with 2005 by some 2 percentage points;
- strong liquidity and benign credit conditions put pressure on lending margins in corporate and commercial banking and credit spreads tightened as a consequence. Increased competition for core deposits also reduced deposit spreads in certain markets;
- HSBC deployed an increased proportion of liabilities into trading assets. Reported net interest income includes the cost of internally funding these assets, while related revenue is included in trading income. This was particularly relevant to the UK, France and the US. The cost of funding net long positions is included within trading as an interest expense in HSBC's customer group reporting; and
- HSBC concentrated balance sheet expansion on attracting liabilities and, as a result, customer deposits, at constant currency but including acquisitions, grew by 3 percentage points more than customer loans. In **Europe**, net interest income increased by 1 per cent. The benefit of balance growth in Personal Financial Services and Commercial Banking was substantially offset by the increased deployment of liabilities to the fund trading activity referred to

above; there was a corresponding rise in trading income. This was most pronounced in the UK and France.

In the UK, growth in Personal Financial Services was strong in savings and packaged current accounts, but mortgage and credit card lending also increased. In Commercial Banking, customer recruitment boosted growth in deposit balances and spreads widened, particularly on US dollar denominated accounts. Commercial lending balances were higher, in part reflecting the strong growth throughout 2005. In France, revenues declined despite growth in lending, due to competitive pricing pressures and the impact of older, higher-yielding hedges of the network's funding surplus maturing. Global Banking and Markets' balance sheet management revenues declined as the rising trend in short-term interest rates continued to flatten yield curves.

In **Hong Kong**, net interest income rose by 15 per cent. Deposit spreads widened with progressive interest rate rises, and balances increased as customers took advantage of higher rates. HSBC supported this growth with a number of promotions and marketing campaigns during the year. In Personal Financial Services, average savings and deposit balances rose by 7 per cent. The launch of a simplified mortgage pricing structure helped

boost mortgage balances and grow market share. A clear focus on sales and targeted marketing helped achieve strong growth in credit card balances, and the number of cards in issue rose by 17 per cent to 4.6 million. Average corporate lending balances rose as the economy gained momentum and investment was channelled into mainland China. The benefit of these developments, however, was substantially offset by spread compression through the rising cost of funds, and lower balance sheet management revenues as short-term interest rates continued to rise, and yield curves remained flat.

In **Rest of Asia-Pacific**, a 25 per cent rise in net interest income was fuelled by balance sheet growth in Personal Financial Services and Commercial Banking. This reflected HSBC's continuing investment in growing the business through network expansion, customer recruitment and targeted marketing and promotions. In Personal Financial Services, the emphasis on the recruitment of HSBC Premier customers generated strong deposit growth throughout the region, which funded increased mortgage and credit card borrowing. Other unsecured lending balances also grew significantly, as HSBC expanded its consumer finance operations in India, Australia and Indonesia. In corporate and commercial banking, increased deposits raised

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through customer recruitment and through higher transactional balances in the payments and cash management and the custody businesses were significant to the growth in net interest income. On the asset side, growth reflected strong demand for credit as regional economies continued to expand and trade flows increased.

In **North America**, net interest income increased by 3 per cent. In the US Personal Financial Services business, strong growth in mortgages, cards, and other personal unsecured non-credit card lending was funded by a 21 per cent rise in average deposits to US\$32.2 billion. This was led by the continued success of the online savings product which grew by US\$6 billion to US\$7 billion at 31 December 2006. Higher spreads in credit cards, reflecting a lower proportion of promotional balances and a degree of re-pricing, were in contrast with most other portfolios. Overall, asset spreads contracted, driven by the effect on funding costs of a succession of interest rate rises, while competitive pricing and customer migration to higher yielding products reduced spreads on deposits. Net interest income was boosted in Canada by strong lending to personal and commercial customers, supported by deposit raising initiatives. However, these benefits were partly offset by lower Global Banking and Markets' balance sheet management income as spreads narrowed as a result of higher short-term rates coupled with a flat yield curve in the US. The increased deployment of liabilities to fund trading

activity also reduced growth in net interest income, with a corresponding increase in trading income.

In **Latin America**, net interest income increased by 17 per cent. In Mexico, deposit growth was boosted by the continuing success of the Tu Cuenta packaged account in Personal Financial Services. Credit card, unsecured lending and mortgage balances also grew strongly, though the benefit of the latter was offset by competitive pressure on spreads. In Brazil, where the domestic economy improved and inflation remained low, rising consumer demand for credit, together with increased sales activity and customer recruitment, drove strong lending growth. Deposits rose through current accounts linked to the growing payroll loan business. Growth in Commercial Banking was mainly in the small and middle market customer segments. HSBC increased focus on these businesses through network expansion and the recruitment of additional sales staff throughout the region. In Global Banking and Markets, improved balance sheet management revenues and growth in the payments and cash management business were the major contributors to interest income growth.

AIEA of US\$1,113 billion were US\$114 billion, or 11 per cent, higher than in 2005. On an underlying basis, growth was 10 per cent. HSBC's net interest margin was 3.10 per cent in 2006, compared with 3.14 per cent in 2005.

**Net fee income**

	Year ended 31 December					
	2007		2006		2005	
	US\$m	%	US\$m	%	US\$m	%
<b>By geographical region</b>						
Europe	8,431	38.3	7,108	41.4	6,299	43.6
Hong Kong	3,362	15.3	2,056	12.0	1,674	11.6
Rest of Asia-Pacific	2,246	10.2	1,622	9.4	1,340	9.3
North America	5,810	26.4	4,766	27.7	3,952	27.3
Latin America	2,153	9.8	1,630	9.5	1,191	8.2
<b>Net fee income</b>	<b>22,002</b>	<b>100.0</b>	17,182	100.0	14,456	100.0



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*Net interest income*

	Year ended 31 December		
	2007 US\$m	2006 US\$m	2005 US\$m
Cards <sup>1</sup>	<b>6,496</b>	5,367	4,462
Account services	<b>4,359</b>	3,633	3,132
Funds under management	<b>2,975</b>	2,718	1,831
Broking income	<b>2,012</b>	1,354	1,104
Insurance <sup>1</sup>	<b>1,836</b>	1,358	1,319
Global custody	<b>1,404</b>	797	656
Credit facilities	<b>1,138</b>	922	880
Unit trusts	<b>875</b>	520	388
Imports/exports	<b>866</b>	780	722
Remittances	<b>556</b>	472	396
Corporate finance	<b>409</b>	255	211
Underwriting	<b>367</b>	286	274
Trust income	<b>299</b>	248	199
Taxpayer financial services	<b>252</b>	263	243
Maintenance income on operating leases	<b>139</b>	122	180
Mortgage servicing	<b>109</b>	97	76
Other	<b>2,245</b>	1,888	1,413
	<b>26,337</b>	21,080	17,486
Less: fee expense	<b>(4,335)</b>	(3,898)	(3,030)
Net fee income	<b>22,002</b>	17,182	14,456

1 *Comparative information has been restated to conform with the current year's presentation.*

Year ended 31 December 2007 compared with year ended 31 December 2006

Net fee income increased by 28 per cent to US\$22.0 billion, 23 per cent on an underlying basis. The commentary that follows is on an underlying basis.

- Buoyant stock markets in Hong Kong and throughout the Rest of Asia-Pacific region resulted in markedly higher income from wealth management products, broking services and global custody in the region.

-

Card fee income increased, mainly in the US and Mexico. Income growth in the US was driven by higher late and over-limit fees.

Merchandising and services fees also increased. In Mexico, the credit card business continued to grow, both in balances and in transaction volumes.

- Increased customer activity in Europe, North America and Latin America were the main drivers for increased account services income. In the US, growth in credit card balances triggered a higher use of the Intellicheck service, which resulted in higher account services income. In the UK, growth in the sale of fee-based packaged accounts contributed to growth in account services fees.

In **Europe**, fee income rose by 11 per cent. Account services increased on higher customer balances and volumes of transactions, supported by

sales of fee-earning packaged accounts in the UK. In France, HSBC recorded an increase in transaction volumes while growth in client assets resulted in higher commission income in Private Banking. Card fees increased in the UK and Turkey, mainly on interchange and acquiring fees. This was partly offset by a reduction in default fees in the UK following regulatory intervention by the OFT in 2006. Broking income increased in the UK, Germany and Switzerland, mainly driven by growth in client assets and transaction volumes. Funds under management decreased on lower income from the Hermitage Fund due to the part sale of fund holdings.

In **Hong Kong**, buoyant stock market activity drove income on a number of commission lines. Broking and global custody income rose as larger trading volumes were registered on higher stock exchange daily turnover. This was enhanced by the launch of new investment schemes, awareness campaigns and the adoption of a new portfolio wealth management sales tool in the branch network. An increase in IPO activity through Hong Kong, mainly derived from mainland China, positively affected underwriting fees. Life insurance commission income increased, boosted by the launch of new products.

In **Rest of Asia-Pacific**, fee income increased by 34 per cent. Buoyant stock markets stimulated customer appetite for unit trusts and other investment products. Strong investment sales were recorded in India, Philippines, South Korea,



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Singapore and mainland China. Security services increased, driven by a sustained level of transaction volumes and investment flows. In the Middle East, increases were registered in cards, global custody, credit facilities and insurance. Increased trade services income in the region reflected higher intra-regional trade flows, which were driven by strong economic performance.

In **North America**, card fee income rose as a result of higher balances attracting late and over-limit fees. The Intellicheck service, which allows customers to pay their credit card balances over the telephone for a fee, proved popular with customers. Revenues from enhancement services on cards which offer services such as debt protection and identity protection, rose on higher sales. Payments and cash management fees also increased on higher volumes generated. Canada registered growth in investor administration fees and fees on the immigrant investor programme. Account services fees also increased.

In **Latin America**, card fee income rose, mainly due to increased volumes and balances in Mexico. The use of debit and credit cards grew, in part driven by the extended ATM network. Strong growth in customer accounts delivered higher transactional fees and the continuing success of the Tu Cuenta product led to increased take-up with higher product fees charged to customers. Lending-related fees increased in Brazil, aided by higher current account and payments and cash management fees.

Year ended 31 December 2006 compared with year ended 31 December 2005

Net fee income of US\$17.2 billion was 19 per cent higher than in 2005, or 16 per cent higher on an underlying basis. The commentary that follows is on an underlying basis.

- Robust global stock market performance, particularly in emerging markets, led to increased customer appetite for equity-based products. HSBC responded by launching new investment products and increasing promotional activity, which contributed to higher unit trust, broking and custody fees.
- There was an increase in cards in issue, which drove higher transaction volumes and balances and led to a 16 per cent rise in card fee income, principally in the US;
- Strong equity market performance also benefited HSBC's asset management activities. Funds under management grew by 16 per cent and performance fees rose strongly, most notably in HSBC's BRIC (Brazil, Russia, India and China) funds and in the Hermitage Fund, a leading fund investing in Russia.
- The successful promotion of packaged account products which, together with increased customer numbers and higher transaction volumes, led to a 13 per cent rise in account services fees. Higher cross-border currency flows led to increased remittance income.
- Reduced sales of creditor insurance products in the UK were largely offset by higher fees in HSBC's Latin American insurance businesses, particularly in Argentina and Brazil.
- Increased taxpayer services fees, higher income from investment and other services provided by HSBC's insurance businesses, and increased corporate and WTAS advisory fees in the US contributed to the increase in other fee income.

In **Europe**, account service fees increased as a result of customer acquisition, higher sales of packaged products and increased transaction volumes. Rising stock markets led to higher sales of investment products and growth in funds under management, while product mix improvements and service enhancements also contributed to a rise in investment fees. Higher performance fees in respect of the Hermitage Fund contributed an additional US\$23 million in fee income, net of performance fees paid to the fund's investment advisor. Offsetting these increases, HSBC's decision to constrain unsecured lending growth in the UK resulted in lower creditor protection insurance fees.

In **Hong Kong**, a buoyant IPO market together with product launches and enhancements contributed to higher sales of investment products; this was augmented by increased transaction volumes following strong growth in local and regional equity markets. As global customers continued to seek investment opportunities in emerging markets, funds under management increased. Growth in cards in issue led to higher card fees.

In **Rest of Asia-Pacific** , higher trade and remittance flows led to increased payments and cash management income. Investment flows into emerging market funds triggered growth in custody and funds administration fees, while rising equity markets and product launches contributed to increased investor demand and higher income from custody, brokerage and the sale of investments.

In **North America** , card fees increased as a result of higher balances and improved interchange rates, while private label card fees benefited from renegotiations with a number of merchants.

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**Net trading income**

Increases in 2006 were partly offset by the effect of FFIEC guidance, which limits certain fee billings for non-prime credit card accounts. Following its launch in 2005, activity within HSBC's mortgage-backed securities business increased rapidly during 2006. As a result, a greater proportion of loans originated by HSBC were sold to the secondary market and mortgage servicing fees grew accordingly, while income in the mortgage-backed securities business also rose. Tariff increases contributed to higher account service fees. Higher business volumes led to a rise in taxpayer services fees, while the WTAS

business progressed strongly, expanding its customer base and reporting significantly higher fee income.

In **Latin America**, increased cards in circulation and improvements in activation times led to higher card issuing fees, while growth in the merchant customer base led to a rise in card acquiring income. Account servicing fees benefited from higher packaged account sales, enhancements to other current account products, price increases and greater transaction volumes. The expansion of HSBC's ATM network in Mexico drove higher ATM fees.

**Net trading income**

	Year ended 31 December					
	2007		2006		2005	
	US\$m	%	US\$m	%	US\$m	%
<b>By geographical region</b>						
Europe	6,943	70.6	4,529	55.1	3,036	51.7
Hong Kong	1,242	12.6	617	7.5	546	9.3
Rest of Asia-Pacific	1,643	16.7	1,181	14.4	860	14.7
North America	(542)	(5.5)	1,358	16.5	885	15.1
Latin America	548	5.6	537	6.5	537	9.2
Net trading income <sup>1</sup>	9,834	100.0	8,222	100.0	5,864	100.0

	Year ended 31 December		
	2007	2006	2005
	US\$m	US\$m	US\$m
Trading activities	4,521	5,465	3,884
Net interest income on trading activities	5,376	2,603	2,208
Other trading income Hedge ineffectiveness:			

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□ on cash flow hedges	<b>(77)</b>	(122)	(96)
□ on fair value hedges	<b>19</b>	16	14
Non-qualifying hedges	<b>(5)</b>	260	(146)
	<hr/>	<hr/>	<hr/>
Net trading income <sup>1</sup>	<b>9,834</b>	8,222	5,864
	<hr/>	<hr/>	<hr/>

1 *The cost of internal funding of trading assets increased by US\$2.8 billion and is excluded from the reported □Net trading income□ line and included in □Net interest income□. However, this cost is reinstated in □Net trading income□ in HSBC□s customer group and global business reporting.*

Year ended 31 December 2007 compared with year ended 31 December 2006

Net trading income increased by 20 per cent to US\$9.8 billion, 13 per cent on an underlying basis. The following commentary is on an underlying basis.

In line with Global Banking and Markets□ focus on emerging markets, total income from trading in Asia and Latin America increased by 42 per cent, dominated by foreign exchange trading and reflecting the benefit of HSBC□s strong and diversified distribution network.

Net trading income was significantly affected by a total of US\$2.1 billion of write-downs on credit trading, leveraged and acquisition financing positions, and monoline credit exposures resulting

from deterioration in the credit market in the second half of the year. The write-downs arose mainly in the US and, to a lesser extent, the UK.

Income from foreign exchange trading increased by 40 per cent, a record result. Revenues were driven by higher customer volumes, against the backdrop of a weakening US dollar and greater market volatility.

A trading loss of US\$419 million in Credit and Rates compared with income of US\$1.3 billion in 2006. US\$1.1 billion of this arose in the second half of 2007. This was due to the write-downs discussed above.

Trading income from structured derivatives fell by 26 per cent. The structured credit business incurred losses in the second half of the year due to the difficult trading conditions described above.

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This was partly offset by higher trading income from other structured derivative products, following investment made in technical expertise and systems in previous years.

Record results were achieved in the equities business reflecting strong growth across all regions particularly in Europe, which benefited from effective product differentiation, notably in emerging market products.

In **Europe**, trading income increased by 41 per cent, driven by the equities business and foreign exchange trading, where income increased strongly, with volume and profitability driven by market volatility. This was partly offset by the write-downs in credit, structured derivatives and leveraged and acquisition finance.

Net trading income in Europe increased following the strategic decision to expand the collateralised lending and structured derivatives businesses, the funding costs of which are reported in "Net interest income".

Income growth in **Hong Kong** was achieved throughout the Global Markets business, assisted by investments made in recent years to grow the product range and customer base. HSBC had only very limited exposure to asset-based securities and structured credit products in Hong Kong.

Strong growth was delivered in **Rest of Asia-Pacific**, led by foreign exchange trading, with higher volumes driven by increased volatility which, in turn, increased customer demand for risk management products.

HSBC's operations in **North America** incurred a trading loss following write-downs in credit, structured derivatives, and leveraged and acquisition finance for the reasons noted above. This was compounded by trading losses on purchased loans in the mortgage services wholesale business in response to which, HSBC closed the business. By contrast, foreign exchange recorded a strong performance, supported by activity generated by the declining US dollar and volatile markets.

Year ended 31 December 2006 compared with year ended 31 December 2005

Net trading income increased significantly in comparison with 2005, reflecting the investment made in widening Global Markets' product range and developing its sales and execution capabilities. Positive revenue trends were recorded in key product areas, although the rate of income growth slowed in the second half of the year, principally due to lower

market volatility and a decrease in deal volumes in the third quarter.

Income from structured derivatives grew by 74 per cent, as investments in technical expertise and systems enabled HSBC to address a broader spectrum of client needs. Increased market volatility, together with expansion in the provision of structured fund products, resulted in higher customer volumes. As the business matured and markets deepened and became more transparent, revenues were boosted by a rise of US\$193 million in the recognition of income deferred in previous periods.

Foreign exchange income remained strong throughout 2006, principally driven by an increase in customer activity encouraged by US dollar weakness and volatility in emerging markets. In the metals trading business, revenues doubled, primarily due to the underlying strength in precious metals and increased price volatility.

Within the credit and rates business, higher gains from interest rate derivatives and emerging market bonds reflected increased volumes of new deals, a tightening of credit spreads and greater interest rate volatility.

In **Europe**, a significant increase in trading income was driven by higher foreign exchange flows and a greater focus on emerging market products. Overall, customer volumes rose, as increased hedging activity and a change in risk appetite among investors drove a general improvement in market sentiment towards developing economies.

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On an underlying basis trading income in **Rest of Asia-Pacific** grew by 35 per cent, driven by HSBC's strong distribution network and experience in developing markets activity, which contributed to particularly strong increases reported in India the Middle East and mainland China.

Performance in HSBC's operations in **the US** remained robust benefiting, in part, from the first full year contribution from the US residential mortgage-backed securities business and successful product launches in structured derivatives.

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*Net income from financial instruments designated at fair value***Net income from financial instruments designated at fair value**

	Year ended 31 December 2007		At 31 December 2007	
	Net income		Assets	Liabilities
	US\$m	%	US\$m	US\$m
<b>By geographical region</b>				
Europe	1,226	30.0	30,058	50,077
Hong Kong	676	16.6	7,253	4,412
Rest of Asia-Pacific	111	2.7	886	501
North America	1,750	42.9	□	34,949
Latin America	320	7.8	3,367	□
	<b>4,083</b>	<b>100.0</b>	<b>41,564</b>	<b>89,939</b>

	Year ended 31 December 2006		At 31 December 2006	
	Net income		Assets	Liabilities
	US\$m	%	US\$m	US\$m
<b>By geographical region</b>				
Europe	144	21.9	12,164	32,630
Hong Kong	260	39.6	4,745	4,291
Rest of Asia-Pacific	79	12.0	1,729	410
North America	(63)	(9 .6)	□	32,880
Latin America	237	36.1	1,935	□
	<b>657</b>	<b>100.0</b>	<b>20,573</b>	<b>70,211</b>

	Year ended 31 December 2005		At 31 December 2005	
	Net income		Assets	Liabilities
	US\$m	%	US\$m	US\$m

## By geographical region

Europe	362	35.0	9,077	27,442
Hong Kong	(6)	(0.6)	3,909	3,999
Rest of Asia-Pacific	58	5.6	872	300
North America	434	42.0	□	29,934
Latin America	186	18.0	1,188	154
	<u>1,034</u>	<u>100.0</u>	<u>15,046</u>	<u>61,829</u>

	<b>2007</b>	2006	2005
	<b>US\$m</b>	US\$m	US\$m
Net income/(expense) arising from:			
financial assets held to meet liabilities under			
□ insurance and investment contracts	<b>2,056</b>	1,552	1,760
□ liabilities to customers under investment contracts	<b>(940)</b>	(1,008)	(1,126)
HSBC's long-term debt issued and related			
□ derivatives	<b>2,812</b>	(35)	403
□ change in own credit spread on long-term debt	<b>3,055</b>	(388)	(70)
□ other changes in fair value	<b>(243)</b>	353	473
other instruments designated at fair value and			
□ related derivatives	<b>155</b>	148	(3)
	<u>4,083</u>	<u>657</u>	<u>1,034</u>
Net income from financial instruments designated at fair value			

HSBC adopted □Amendment to IAS 39 Financial Instruments: Recognition and Measurement: the Fair Value Option□ with effect from 1 January 2005. HSBC may designate financial instruments at fair value under the option in order to remove or reduce accounting mismatches in measurement or recognition, or where financial instruments are managed, and their performance is evaluated, together on a fair value basis. All income and expense on financial instruments for which the fair value option was taken were included in this line

except for issued debt securities and related derivatives, where the interest components were shown in interest expense.

HSBC used the fair value designation principally in the following instances:

- for certain fixed-rate long-term debt issues whose interest rate characteristic has been changed to floating through interest rate swaps, as part of a documented interest rate management strategy. Approximately



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US\$66 billion (2006: US\$56 billion) of the Group's debt issues have been accounted for using the fair value option. The movement in fair value of these debt issues includes the effect of own credit spread changes and any ineffectiveness in the economic relationship between the related swaps and own debt;

- as credit spreads narrow, accounting losses are booked, and the reverse is true in the event of spreads widening. Ineffectiveness arises from the different credit characteristics of the swap and own debt coupled with the sensitivity of the floating leg of the swap to changes in short-term interest rates. In addition, the economic relationship between the swap and own debt can be affected by relative movements in market factors, such as bond and swap rates, and the relative bond and swap rates at inception. The size and direction of the accounting consequences of changes in own credit spread and ineffectiveness can be volatile from period to period, but do not alter the cash flows envisaged as part of the documented interest rate management strategy;
- for certain financial assets held by insurance operations and managed at fair value to meet liabilities under insurance contracts, and certain liabilities under investment contracts with discretionary participation features (DPF), approximately US\$17 billion of assets (2006: US\$6 billion); and
- for financial assets held by insurance operations and managed at fair value to meet liabilities under investment contracts, approximately US\$14 billion of assets (2006: US\$12 billion).

Net income from financial assets designated at fair value which are held to support liabilities for both insurance and investment contracts, is presented as Net income from financial instruments designated at fair value. For investment contracts, where the liabilities to policyholders are designated at fair value, the movement in the value of the liabilities is presented in Net income from financial instruments designated at fair value in the income statement. However, for insurance contracts, the movement in liabilities arising from the net income allocated to the policyholder is presented in Net insurance

claims incurred and movement in liabilities to policyholders.

Year ended 31 December 2007 compared with year ended 31 December 2006

Credit spreads widened significantly in the second half of 2007, leading to a substantial increase in net income from financial instruments designated at fair value compared with 2006. This was primarily driven by a widening in credit spreads on certain fixed-rate long-term debt, issued by HSBC Holdings and its subsidiaries. These cumulative gains will fully reverse over the life of the debt. The cumulative adjustment to reserves where the policy is applied for the first time and, subsequently, the income statement in terms of change in own credit spread since the fair value option was available, is US\$1.6 billion after taking account of the US\$3.1 billion credit in 2007.

Income from assets held to meet liabilities under insurance and investment contracts also rose by 32 per cent, mostly from premium growth and higher investment returns on the portfolios held by the insurance businesses in the UK and Hong Kong. The change in fair value of liabilities under investment contracts declined by 7 per cent.

Year ended 31 December 2006 compared with year ended 31 December 2005

Net income from financial instruments designated at fair value decreased compared with 2005. This was primarily driven by a narrowing (i.e. improvement) in credit spreads on certain fixed-rate long-term debt issued by HSBC Finance and lower net mark-to-market movements on this debt and the related interest rate swaps. During 2006, HSBC Finance's debt received improved ratings from both Moody's and S&P. Perversely, this improvement generated accounting losses of some US\$388 million which will reverse over the residual maturity of the debt instruments.

Income from assets held to meet liabilities under insurance and investment contracts was some 12 per cent lower, reflecting movements in the market values of assets. The increase in the fair value of liabilities under investment contracts was 10 per cent lower than in 2005.



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*Gains less losses from financial investments / Net earned insurance premiums*

**Gains less losses from financial investments**

Year ended 31 December

	2007		2006		2005	
	US\$m	%	US\$m	%	US\$m	%
<b>By geographical region</b>						
Europe	<b>1,326</b>	<b>67.9</b>	624	64.4	439	63.4
Hong Kong	<b>94</b>	<b>4.8</b>	162	16.7	108	15.6
Rest of Asia-Pacific	<b>38</b>	<b>1.9</b>	41	4.2	18	2.6
North America	<b>245</b>	<b>12.5</b>	58	6.0	47	6.8
Latin America	<b>253</b>	<b>12.9</b>	84	8.7	80	11.6
Gains less losses from financial investments	<b>1,956</b>	<b>100.0</b>	969	100.0	692	100.0

Year ended 31 December

	2007 US\$m	2006 US\$m	2005 US\$m
Net gain from disposal of:			
□ debt securities	<b>120</b>	252	138
□ equity securities	<b>1,822</b>	702	505
□ other financial investments	<b>14</b>	15	7
	<b>1,956</b>	969	650
Recovery of impairment losses	□	□	42
Gains less losses from financial investments	<b>1,956</b>	969	692

Year ended 31 December 2007 compared with year ended 31 December 2006

Net gains of US\$2.0 billion were reported by HSBC as a result of the disposal of financial investments during 2007, 102 per cent higher than in 2006, 93 per cent on an underlying basis. The following commentary is on an underlying basis.

In **Europe**, the sale of shareholdings and various equity investments in the UK and France, including the disposal of shares in Euronext (the European stock exchange), contributed to net gains of US\$1.3 billion, an increase of 101 per cent from 2006. In Private Banking, gains of US\$91 million arose from the sale of a further holding in the Hermitage Fund, compared with US\$117 million in 2006.

In **Hong Kong**, gains were 42 per cent less than in 2006 as a result of the non-recurrence of a US\$101 million gain on the partial sale of HSBC's stake in UTI Bank Limited, an Indian retail bank, in that year.

Gains of US\$245 million in **North America** were primarily attributable to the sale of shares in MasterCard and gains in **Latin America** largely arose from the sale of equity holdings in Brazil, including HSBC's holding in a credit bureau.

Year ended 31 December 2006 compared with year ended 31 December 2005

HSBC reported net gains of US\$969 million from the disposal of available-for-sale financial

investments during 2006, 40 per cent higher than in 2005. On an underlying basis, gains were 35 per cent greater than in 2005. Gains from financial investments were mainly attributable to the following transactions:

- a gain of US\$93 million arising from the partial redemption of HSBC's investment in MasterCard Incorporated following its IPO in May. The gain was distributed across all geographic regions as most HSBC Group banks were members of MasterCard;
- a gain of US\$101 million on the sale of part of HSBC's stake in UTI Bank Limited, an Indian retail bank;
- the partial sale by Private Banking of a holding in the Hermitage Fund contributed a gain of US\$117 million for the year; and
- the sale of a portfolio of structured finance investments, classified as debt securities, contributed a gain of US\$112 million.

Gains arising from dilution of interests in associates

HSBC's associates, Industrial Bank, Ping An Insurance and Bank of Communications in mainlandChina; Financiera Independencia in Mexico and Techcombank in Vietnam, issued new shares for which HSBC did not subscribe. As a consequence of the new monies raised by the associates, HSBC's share of their underlying assets increased by US\$1.1 billion, notwithstanding the reduction in the Group's interests. These gains are presented in the

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income statement as [Gains from dilution of the Group's interests in associates], and should be regarded as exceptional. For further details see Note 4 on the Financial Statements.

	Year ended 31 December					
	2007		2006		2005	
	US\$m	%	US\$m	%	US\$m	%
<b>By geographical region</b>						
Europe	4,010	44.2	1,298	22.9	1,599	29.4
Hong Kong	2,797	30.8	2,628	46.3	2,334	42.9
Rest of Asia-Pacific	226	2.5	174	3.1	155	2.9
North America	449	4.9	492	8.7	477	8.8
Latin America	1,594	17.6	1,076	19.0	871	16.0
Net earned insurance premiums	<b>9,076</b>	<b>100.0</b>	5,668	100.0	5,436	100.0

	Year ended 31 December		
	2007 US\$m	2006 US\$m	2005 US\$m
Gross insurance premium income	11,001	6,455	6,152
Reinsurance premiums	(1,925)	(787)	(716)
Net earned insurance premiums	<b>9,076</b>	5,668	5,436

Year ended 31 December 2007 compared with year ended 31 December 2006

Net earned insurance premiums of US\$9.1 billion were 60 per cent higher than in 2006. This was boosted by HSBC's acquisition in the first half of 2007 of the remaining shares in HSBC Assurances in France and the purchase of HSBC Bank Panama in Central America in late 2006. Underlying net insurance premiums grew by 21 per cent. The following commentary is on an underlying basis.

In **Europe**, net earned insurance premiums increased by 50 per cent to US\$4.0 billion, including growth of the Guaranteed Income Bond and motor insurance, and the introduction of enhanced death benefits to pension contracts in the UK. Premiums also grew in the UK because of a higher retention of risk compared with 2006, when a greater proportion of risk and corresponding premiums were ceded to reinsurers. There were also significant contributions from increased reinsurance business in Ireland and from the life assurance business in Malta.

In **Hong Kong**, net earned insurance premiums increased by 7 per cent to US\$2.8 billion, as the life assurance business expanded with the launch of new products.

In the **Rest of Asia-Pacific** region, net earned insurance premiums increased by 24 per cent to US\$226 million. This growth was mainly generated in Malaysia by the HSBC Amanah Takaful business which was launched in late 2006, offering *shariah*-compliant insurance products.

In **North America**, net earned insurance premiums decreased by 9 per cent to US\$449 million, as the decline in loan volumes led to a fall in credit insurance sales and HSBC stopped reinsuring credit insurance for other lenders.

In **Latin America**, net earned insurance premiums increased by 32 per cent to US\$1.6 billion. There was good growth in all of HSBC's insurance businesses in the region. Higher premiums in Brazil were driven by increased sales of pension products with linked-life policies. In Argentina, the growth was led by the motor insurance businesses and, in Mexico, the primary driver was life assurance.

Year ended 31 December 2006 compared with year ended 31 December 2005

Net earned insurance premiums of US\$5.7 billion were 4 per cent higher than in 2005, 3 per cent on an underlying basis. The commentary that follows is on an underlying basis.

In **Europe**, net earned premium income decreased by 19 per cent to US\$1.3 billion. This was largely in the UK, where lower sales of single premium insurance contracts, a lower market appreciation of investment assets and the effect of changes in reinsurance arrangements were the principal drivers of the decrease.

In **Hong Kong**, net earned premium income increased by 13 per cent, driven by the life insurance business. New products, many designed to meet financial needs identified in HSBC's global study on the future of retirement, were supported by increased

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*Other operating income*

promotional and marketing activity, and the development of internet and telephone distribution channels. Sales rose in consequence.

In **Rest of Asia-Pacific**, net earned premium income rose by 5 per cent growth to US\$174 million. This was concentrated in Singapore and reflected the success of new product launches, supported by increased marketing. Increased sales of individual life policies were the main driver of the growth. HSBC continued to expand its insurance business across Rest of Asia-Pacific with a number of initiatives including the establishment of HSBC's first Islamic insurance company in Malaysia.

In **North America**, the modest rise in net premium income to US\$492 million reflected growth from new life business underwritten in 2006, which

was substantially offset by a decline in the non-life business.

Improved cross-selling drove growth across **Latin America**, and income rose by 18 per cent to US\$1.1 billion. In Mexico, growth in individual life, casualty and motor insurance was partly offset by increased reinsurance costs. In Brazil, growth was led by strong sales of both life and pension products. In Argentina, increased advertising partnerships with established local consumer brands and internal cross-selling initiatives led to a rise in motor, home and extended-warranty insurance premium income. This was, in part, offset by the effects of the disposal of the Brazilian general insurer HSBC Seguros during the latter half of 2005, which resulted in a significant reduction in non-life premium income.

**Other operating income**

Year ended 31 December

	2007		2006		2005	
	US\$m	%	US\$m	%	US\$m	%
<b>By geographical region</b>						
Europe	1,193	34.8	1,428	35.4	1,603	43.7
Hong Kong	845	24.7	834	20.6	805	21.9
Rest of Asia-Pacific	798	23.3	765	18.9	335	9.1
North America	360	10.5	922	22.8	642	17.5
Latin America	228	6.7	91	2.3	286	7.8
	<b>3,424</b>	<b>100.0</b>	<b>4,040</b>	<b>100.0</b>	<b>3,671</b>	<b>100.0</b>
Intra-HSBC elimination	<b>(1,985)</b>		<b>(1,494)</b>		<b>(938)</b>	

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Other operating income	<b>1,439</b>	2,546	2,733
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	Year ended 31 December		
	<b>2007</b>	2006	2005
	<b>US\$m</b>	US\$m	US\$m
Rent received	<b>630</b>	687	859
Gains recognised on assets held for sale	<b>5</b>	28	11
Valuation gains on investment properties	<b>152</b>	164	201
Gain on disposal of property, plant and equipment, intangible assets and non-financial investments	<b>213</b>	781	703
Gain on disposal of operating leases	□	□	26
Change in present value of in-force long-term insurance business	<b>(145)</b>	40	40
Other	<b>584</b>	846	893
<b>Other operating income</b>	<b>1,439</b>	2,546	2,733

Year ended 31 December 2007 compared with year ended 31 December 2006

Other operating income of US\$1.4 billion was 43 per cent lower than in 2006, 51 per cent lower on an underlying basis. The commentary that follows is on an underlying basis.

In **Europe**, other operating income declined by 25 per cent. This largely resulted from a negative movement in the value of in-force business in the UK insurance business. The movement was driven by a change in the calculation methodology of the PVIF business in the first half of 2007 as HSBC

implemented regulatory changes to the rules governing the calculation of insurance liabilities. This had a marginally positive effect on profits as there was a corresponding reduction in policyholder liabilities.

Private equity income decreased significantly, due to the non-recurrence of asset disposals in 2006. Property gains included a gain on the disposal and leaseback of a London building in 2007.

Although HSBC sold its Canary Wharf headquarters building at 8 Canada Square in 2007, the gain remains unrecognised as HSBC continues to



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provide bridge finance for the debt portion of the transaction.

In **Hong Kong**, there was an increase of 2 per cent in other operating income, mainly due to increased cost recoveries from other HSBC sites. This was partially offset by the non-recurrence of income on the sale of the former head office building of Hang Seng Bank and transfer of credit card acquiring business into a joint venture with Global Payments Inc.

Other operating income in **Rest of Asia-Pacific** decreased by 2 per cent. The comparative figures included gains on disposals of certain businesses in Australia. No such gains on disposals were registered this year. Similarly, profits from disposal of assets held for sale decreased due to the non-recurrence of profits on sale of properties in Japan and India.

In **North America**, other operating income decreased significantly, driven by lower prices on sale of real estate due to the general decline in the property market. In addition, there were lower gains on the sale of investments, mainly due to a significant one-off gain in the latter part of 2006.

In **Latin America**, a 97 per cent increase in other operating income reflected the recognition of the embedded value calculation on the PVIF life assurance business in Mexico. The improvement on 2006 was also aided by the non-recurrence of a loss on sale of a portfolio of assets during that year and sundry gains on foreclosed assets in 2007.

Year ended 31 December 2006 compared with year ended 31 December 2005

Other operating income of US\$2.5 billion was 7 per cent lower than in 2005, 9 per cent lower on an underlying basis. The commentary that follows is on an underlying basis.

In **Europe**, other operating income declined by 14 per cent. This largely resulted from the non-recurrence of one-off gains from the restructuring and syndication of assets in Global Investment Banking in 2005. Gains on private equity were also lower. There was a 29 per cent fall in rental income, with a compensating effect on operating expenses, following the sale of the operational functions of HSBC's vehicle financing and fleet management business in 2005, combined with the non-recurrence of gains made in that year on disposal of structured finance leases in the UK. This decline was partly offset by profit recognised on the sale of HSBC's stake in Cyprus Popular Bank Limited of US\$93 million, and income from UK branch sale and lease-back transactions.

In **Hong Kong**, the modest increase in other operating income reflected profits earned from the sale of the former head office building of Hang Seng Bank and income received from the transfer of the credit card acquiring business into a joint venture between HSBC and Global Payments Inc. These factors were partly offset by lower revaluation gains on Hang Seng Bank's investment properties following a slowdown in the rate of property price appreciation and the non-recurrence of the disposal of a leasehold residential property.

Other operating income in **Rest of Asia-Pacific** more than doubled, reflecting profits earned from various business disposals in Australia and the sale of an office building in Japan. Higher levels of activity at the Group Service Centres resulted in rising income in the region and contributed further to the increase.

In **North America**, the 42 per cent increase largely resulted from gains on the disposal of various investments and real estate, and higher lease income from property investments by Amanah Finance.

The 73 per cent decline in **Latin America** was mainly driven by the non-recurrence of the receipt of coverage bonds issued as compensation for asymmetric pesification in Argentina last year. The non-recurrence of the gain on sale of the insurance underwriter, HSBC Seguros, in Brazil in 2005 (US\$89 million) contributed further to the reduction.



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*Net insurance claims / Loan impairment charges*
**Net insurance claims incurred and movement in liabilities to policyholders**

	Year ended 31 December					
	2007		2006		2005	
	US\$m	%	US\$m	%	US\$m	%
<b>By geographical region</b>						
Europe	3,479	40.4	531	11.3	818	20.1
Hong Kong	3,208	37.3	2,699	57.4	2,059	50.6
Rest of Asia-Pacific	253	2.9	192	4.1	166	4.1
North America	241	2.8	259	5.5	232	5.7
Latin America	1,427	16.6	1,023	21.7	792	19.5
Net insurance claims incurred and movement in liabilities to policy holders	<b>8,608</b>	<b>100.0</b>	4,704	100.0	4,067	100.0

	Year ended 31 December		
	2007 US\$m	2006 US\$m	2005 US\$m
Gross insurance claims and movement in liabilities to policyholders	9,550	5,072	4,153
Reinsurers' share of claims incurred and movement in liabilities to policyholders	(942)	(368)	(86)
Net insurance claims incurred and movement in liabilities to policy holders <sup>1</sup>	<b>8,608</b>	4,704	4,067

1 *Net insurance claims incurred and movement in liabilities to policyholders arise from both life and non-life insurance business. For non-life business, amounts reported represent the cost of claims paid during the year and the estimated cost of notified claims. For life business, the main element of claims is the liability to policyholders created on the initial underwriting of the policy and any subsequent movement in the liability that arises, primarily from the attribution of investment performance to savings-related policies. Consequently, claims rise in line with increases in sales of savings-related business and with investment market growth.*

Year ended 31 December 2007 compared with year ended 31 December 2006

Net insurance claims incurred and movement in liabilities to policyholders of US\$8.6 billion were 83 per cent higher than in 2006. In March 2007, HSBC acquired the remaining shares in HSBC Assurances in France and purchased HSBC Bank Panama in late 2006. Net insurance claims incurred and movement in liabilities to

policyholders increased by 32 per cent on an underlying basis.

The following commentary is on an underlying basis.

In **Europe**, net insurance claims incurred and movement in liabilities to policyholders grew by 121 per cent to US\$3.5 billion. This growth was in parallel with the growth in net earned insurance premiums, including maintaining a higher level of risk, but it was offset by FSA rule changes which led to lower claims valuation on life policies. There was also a rise in flood-related claims in the UK after record rainfalls during the summer.

In **Hong Kong**, net insurance claims incurred and movement in liabilities to policyholders increased by 19 per cent to US\$3.2 billion. The increase was more significant than premium growth because many of the liabilities were related to life policies. Policyholders participate in the investment performance of assets supporting these liabilities and

the investment return on these assets is shown in [Net income from financial instruments designated at fair value].

In the **Rest of Asia-Pacific** region, net insurance claims incurred and movement in liabilities to policyholders rose by 25 per cent to US\$253 million.

Net insurance claims incurred and movement in liabilities to policyholders decreased by 7 per cent to US\$241 million in **North America**, in line with the change in net earned insurance premiums.

In **Latin America**, net insurance claims incurred and movement in liabilities to policyholders grew by 26 per cent to US\$1.4 billion. Most of this increase was in Brazil, driven by a rise in policyholders' liabilities on the back of higher life insurance and pension volumes. Growth in the Mexico life business also contributed.

Year ended 31 December 2006 compared with year ended 31 December 2005

Net insurance claims incurred and movement in liabilities to policyholders of US\$4.7 billion were 16 per cent higher than in 2005, 15 per cent on an underlying basis. The commentary that follows is on an underlying basis.

In **Europe**, net insurance claims incurred and movement in liabilities to policyholders decreased

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by 35 per cent to US\$531 million, primarily driven by lower sales of critical illness and creditor protection products, along with the effect of adverse movements in fixed interest rate markets on the value of liabilities to policyholders.

Net insurance claims and movement in liabilities to policyholders in **Hong Kong** increased by 31 per cent, predominantly in the life insurance business, in which reserves for liabilities to policyholders rose with business growth, together with the rising value of investments. Growth in the underwriting of accident and health business resulted in higher non-life insurance claims reserves.

Net insurance claims and movement in liabilities to policyholders in **North America** rose by 12 per cent to US\$259 million, mainly reflecting an increase in reserves for new life insurance business underwritten in 2006.

In **Latin America**, higher sales of life and pension fund products led to an increase in net insurance claims incurred and movement in liabilities to policyholders of 24 per cent to US\$1,023 million. Lower movements in the non-life insurance liabilities were due to the sale of the non-life insurance business, HSBC Seguros, in Brazil during the latter half of 2005.

**Loan impairment charges and other credit risk provisions**

	Year ended 31 December					
	2007		2006		2005	
	US\$m	%	US\$m	%	US\$m	%
<b>By geographical region</b>						
Europe	2,542	14.8	2,155	20.4	1,929	24.7
Hong Kong	231	1.3	172	1.6	146	1.9
Rest of Asia-Pacific	616	3.6	512	4.8	134	1.7
North America	12,156	70.5	6,796	64.3	4,916	63.0
Latin America	1,697	9.8	938	8.9	676	8.7
Total loan impairment charges and other credit risk provisions	17,242	100.0	10,573	100.0	7,801	100.0
As a percentage of net operating income before loan impairment charges and other credit risk provisions		21.8		16.2		13.5
Impairment charges on loans and advances to customers as a percentage of gross average loans and advances to customers		2.1		1.4		1.2

	Year ended 31 December		
	2007	2006	2005
	US\$m	US\$m	US\$m
Loan impairment charges			
New allowances net of allowance releases	18,182	11,326	8,354
Recoveries of amounts previously written off	(1,005)	(779)	(494)

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	<b>17,177</b>	10,547	7,860
Individually assessed allowances	<b>796</b>	458	518
Collectively assessed allowances	<b>16,381</b>	10,089	7,342
Other credit risk provisions	<b>65</b>	26	(59)
<b>Total loan impairment charges and other credit risk provisions</b>	<b>17,242</b>	10,573	7,801
Customer impaired loans	<b>18,304</b>	13,785	11,446
Customer loan impairment allowances	<b>19,205</b>	13,578	11,357

Year ended 31 December 2007 compared with year ended 31 December 2006

Loan impairment charges and other credit risk provisions were US\$17.2 billion, a 63 per cent increase over 2006. The analysis that follows is on an underlying basis.

Loan impairment charges increased by 58 per cent, reflecting:

- substantially higher losses in the US consumer finance loan book, primarily in mortgage lending but also in the credit cards portfolio in the final part of the year. Delinquency rates increased during the year as falling house prices

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HSBC HOLDINGS PLC

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### *Loan impairment charges*

constrained customers' ability to refinance their loans and led to deterioration in credit markets;

- an underlying 7 per cent increase in lending to customers (excluding lending to the financial sector and settlement accounts); and
- a sharp increase in loan impairment charges in Mexico, primarily due to portfolio growth, seasoning, and higher delinquency rates on credit cards; offset by
- a continued benign environment for commercial and corporate credit in all regions.

In **Europe**, loan impairment charges rose by 10 per cent to US\$2.5 billion. Overall credit quality remained broadly stable. In the UK, loan impairment charges rose, primarily in consumer finance lending outside HSBC Bank; within HSBC Bank, steps taken in 2006 to tighten underwriting standards led to an improvement in loan impairment trends. Corporate loan impairment charges remained low in absolute terms although they were 23 per cent higher than the level incurred in 2006. In the UK, increased loan impairment charges principally reflected allowances on two large corporate accounts and the ongoing effect of IVAs on the micro business segment.

Loan impairment charges in **Hong Kong** continued at a low level and in line with 2006 at US\$231 million, despite strong balance sheet growth. This reflected good credit quality and robust economic conditions.

In **Rest of Asia-Pacific**, loan impairment charges rose by 17 per cent to US\$616 million. Loan impairment charges were significantly lower in Taiwan due to the non-recurrence of impairment charges in 2006 which resulted from regulatory intervention in the card market and the imposition of a government debt negotiation scheme. In Indonesia, performance improved on 2006 when loan impairment charges were affected by the introduction of minimum repayment terms. These factors were offset by an increase in corporate loan impairment charges in several countries, higher loan impairment charges in India due to balance sheet growth and higher loss rates on credit cards, and a deterioration in the Malaysian mortgage portfolio due to rising interest rates.

In **North America**, loan impairment charges posted a steep rise, increasing by 79 per cent to US\$12.2 billion. The main factor driving this deterioration was the impact of the weaker housing

market on both economic activity and the ability of borrowers to extend or refinance debt. In addition, seasoning and mix change within the credit cards portfolio, and increases in bankruptcy filings after the exceptionally low levels seen in 2006 following changes in legislation, added to loan impairment charges.

The real estate secured portfolios experienced continuing deterioration in credit quality as a lack of demand for securitised sub-prime mortgages and falls in house prices severely restricted refinancing options for many customers. In the mortgage services business, loan impairment charges rose by 41 per cent to US\$3.1 billion while, in consumer lending, loan impairment charges rose by 139 per cent to US\$4.1 billion. Delinquency rates exceeded recent historical trends, particularly for those loans originated in 2005 and 2006. Performance was weakest in housing markets which had previously experienced the steepest home price appreciation and in respect of second lien products and stated income products.

US card services experienced a rise in loan impairment charges from a combination of growth in balances, higher losses in the final part of the year as the economy slowed, a rise in bankruptcy rates approaching historical levels, and a shift in portfolio mix to higher levels of non-prime loans. Further details are provided on page 220.

In **Latin America**, loan impairment charges rose sharply, by 53 per cent to US\$1.7 billion, driven by portfolio growth, normal seasoning and higher delinquency rates on credit cards. Loan impairment charges for small and medium-sized businesses lending in Mexico also increased. Partly offsetting these was an improvement in personal and commercial delinquency rates in Brazil.

For the Group as a whole, the aggregate outstanding customer loan impairment allowances at 31 December 2007 of US\$19.2 billion represented 2.0 per cent of gross customer advances (net of reverse repos and settlement accounts), compared with 1.6 per cent at year-end 2006. Impaired loans to customers were US\$18.3 billion at 31 December 2007 compared with US\$13.8 billion at 31 December 2006. On a constant currency basis, impaired loans to customers were 28 per cent higher than in 2006 compared with customer lending growth (excluding loans to the financial sector and settlement accounts) of 7 per cent .



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Year ended 31 December 2006 compared with year ended 31 December 2005

The charge for loan impairments and other credit risk provisions was US\$10.6 billion, a 36 per cent increase over that reported in 2005. The analysis that follows is on an underlying basis.

Charges increased by 30 per cent, reflecting:

- increased loss experience in the US mortgage services business, particularly in second lien, portions of first lien and ARMs acquired from correspondent brokers and banks in 2005 and in the first half of 2006;
- 10 per cent underlying lending growth (excluding lending to the financial sector and settlement accounts), notably in the UK, the US, Mexico, Brazil and Asia;
- the continuing effect in the UK of consumer recourse to formal debt mitigation arrangements;
- credit deterioration, principally in the first half of 2006, in unsecured personal and credit card lending in Taiwan and Indonesia; offset by
- the non-recurrence of a surge in bankruptcy filings in the US in the fourth quarter of 2005 and the effect of hurricane Katrina; and
- a continued benign commercial and corporate credit environment.

In **Europe**, net loan impairment charges rose by 10 per cent to US\$2.2 billion. In the UK, net charges rose by a modest 4 per cent as growth in the personal customer impairment charge, which was broadly in line with lending growth, was partially offset by favourable movements on the impairment charge for commercial loans in a robust corporate credit environment. The personal sector continued to experience higher levels of IVA and bankruptcy filings, following an easing of bankruptcy regulations in 2004, growth in consumer indebtedness and a rise in unemployment. This was mitigated by action taken on underwriting and collections. In France, the non-recurrence of several significant recoveries in 2005 resulted in an increase in net loan impairment charges in 2006.

Loan impairment charges in **Hong Kong** remained low at US\$172 million, underpinned by robust personal and commercial credit quality in a strong economy with low unemployment.

In **Rest of Asia-Pacific**, loan impairment charges rose sharply to US\$512 million. Taiwan and Indonesia experienced credit deterioration during 2006, although the problem peaked in the first half

of the year. Taiwan was affected by the imposition of a mandatory government debt renegotiation scheme which allowed customers to extend and heavily discount repayment terms, leading to market-wide credit losses. Indonesia was also affected by regulations, specifically with respect to minimum re-payment terms which compounded higher impairments brought about by a reduction in fuel subsidies. Elsewhere in Rest of Asia-Pacific, credit quality was stable.

In **North America**, the net loan impairment charge increased significantly, by 32 per cent to US\$6.8 billion, largely in the second half of 2006, driven by the credit deterioration in US sub-prime mortgages described in the first bullet point above. The effects of the decline in US house price inflation and rising interest rates during 2006 were accentuated by the increased percentage of second lien loan originations to total loans originated in 2005 and the first half of 2006, and the underwriting of stated income (low documentation) products. The US net loan impairment charges increased by 37 per cent after taking into account the most recent trends in delinquency and loss severity, projecting the probable impact of re-pricing ARMs, and incorporating the effect of re-pricing on second lien loans. Further details are provided on page 217. Credit delinquency in other parts of the mortgage portfolio and in other US businesses rose modestly, driven by unusually low levels at the end of 2005, and growing loan maturity in 2006. Partially offsetting the effects of credit deterioration were a decline in bankruptcy filings following the surge at the end of 2005, relatively low unemployment and a fall in exposure estimated to

result from hurricane Katrina.

In **Latin America**, the rise in impairment charges by 24 per cent to US\$938 million was largely recorded in Mexico and, to a lesser extent, Brazil and Argentina. In Mexico, strong loan growth, particularly in 2006, led to increased loan impairment charges. In Brazil, the credit weaknesses seen in 2005 and the first half of 2006, particularly in the consumer market, were mitigated by changes to underwriting procedures. Net charges in Brazil increased by 7 per cent compared with 54 per cent in 2005 and declined in the second half of 2006 compared with the first half. In Argentina, net charges rose as a result of the non-recurrence of releases and recoveries in 2005.

The aggregate outstanding customer loan impairment allowances at 31 December 2006 of US\$13.6 billion represented 1.6 per cent of gross customer advances (net of reverse repos and

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**Operating expenses**

settlement accounts), compared with 1.5 per cent at the same time in 2005.

Impaired loans to customers were US\$13.8 billion at 31 December 2006

compared with US\$11.4 billion at 31 December 2005. On a constant currency basis, impaired loans were 14 per cent higher than in 2005 compared with lending growth (excluding loans to the financial sector and settlement accounts) of 10 per cent.

**Operating expenses**

	Year ended 31 December					
	2007		2006		2005	
	US\$m	%	US\$m	%	US\$m	%
<b>By geographical region</b>						
Europe	16,525	40.3	13,871	39.6	12,639	41.4
Hong Kong	3,780	9.2	3,269	9.3	2,867	9.4
Rest of Asia-Pacific	4,764	11.6	3,548	10.1	2,762	9.1
North America	10,556	25.7	10,193	29.1	8,758	28.8
Latin America	5,402	13.2	4,166	11.9	3,426	11.3
	<b>41,027</b>	<b>100.0</b>	35,047	100.0	30,452	100.0
Intra-HSBC elimination	(1,985)		(1,494)		(938)	
Total operating expenses	<b>39,042</b>		33,553		29,514	

	Year ended 31 December		
	2007	2006	2005
	US\$m	US\$m	US\$m
<b>By expense category</b>			
Employee compensation and benefits <sup>1</sup>	21,334	18,500	16,145
Premises and equipment (excluding depreciation and impairment)	3,966	3,389	2,977
General and administrative expenses	11,328	9,434	8,206

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Administrative expenses	<b>36,628</b>	31,323	27,328
Depreciation and impairment of property, plant and equipment	<b>1,714</b>	1,514	1,632
Amortisation and impairment of intangible assets	<b>700</b>	716	554
	<hr/>	<hr/>	<hr/>
Total operating expenses	<b>39,042</b>	33,553	29,514
	<hr/>	<hr/>	<hr/>

At 31 December

	<b>2007</b>	2006	2005
<b>Staff numbers (full-time equivalent)</b>			
Europe	<b>82,166</b>	78,311	77,755
Hong Kong	<b>27,655</b>	27,586	25,931
Rest of Asia-Pacific	<b>88,573</b>	72,265	55,577
North America	<b>52,722</b>	55,642	53,608
Latin America <sup>2</sup>	<b>64,404</b>	64,900	55,600
	<hr/>	<hr/>	<hr/>
Total staff numbers	<b>315,520</b>	298,704	268,471
	<hr/>	<hr/>	<hr/>

- 1 A charge of US\$135 million was realised in 2006 arising from the waiver of the TSR-related performance condition in respect of the 2003 awards under the HSBC Holdings Group Share Option Plan (the Plan). As explained in the Annual Report and Accounts 2005, in light of the impressive and sustained performance and shareholder returns over the three years covered by the 2003 awards, the Group Remuneration Committee exercised its discretion, as permitted within the Plan, to waive the TSR performance condition. Under IFRSs, this is treated as a modification which requires an additional accounting charge: this is a non-cash item.*
- 2 Comparative information for 2006 has been restated to bring numbers for Latin America into line with the criteria for the recognition of full-time equivalent staff used in 2007.*

Year ended 31 December 2007 compared with year ended 31 December 2006

Operating expenses increased by US\$5.5 billion to US\$39.0 billion. On an underlying basis, cost growth was 10 per cent, the main drivers being:

- Costs rose in Europe, mainly driven by staff costs in the UK and France and non-staff costs in the UK. The increase in staff costs was driven by a mixture of higher staff benefits and higher headcount in the region. A change in actuarial assumptions regarding the employees' defined contribution pension scheme in the UK also contributed to the increase. General and administrative expenses were driven by ex gratia payments expensed in respect of overdraft fees applied in previous years and a provision for reimbursement of certain charges on historic will trusts and other related services, both in the UK.

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- Staff costs in Asia rose as additional staff numbers were deployed in support of business expansion. Increased salaries reflected the buoyant economic conditions in the region and higher performance pay.
- In North America, costs increased marginally. Origination activities were curtailed or closed in certain segments of consumer finance. The resultant restructuring costs totalled US\$103 million. In Global Banking and Markets, there was lower performance pay partly offset by exit costs on the closure of the mortgage-backed trading business.
- In meeting its commitment to expand operations in fast growing economies, the Group incurred investment expenditure across Asia and Latin America. In the Rest of Asia-Pacific region, costs increased, mainly in the Middle East, India and mainland China, as the branch network was extended. New initiatives were implemented to expand the Group's consumer finance, HSBC Direct and cards businesses. Similarly, in Latin America costs increased from the expansion of the distribution platform, supported by incremental marketing expenditure which delivered higher transactional volumes with related revenues and costs.

In **Europe**, costs increased by 10 per cent, compared with an equivalent growth in net operating income before loan impairment charges. In the UK, a change in actuarial assumptions regarding the staff defined benefit pension scheme led to increased costs. Ex gratia payments were expensed in respect of overdraft fees applied in previous years and a provision for reimbursement of certain charges on historic will trusts and other related services was raised. Costs also increased on investments in technology, investing in straight-through processing and branch refurbishment. Costs rose in payments and cash management on higher transaction volumes. Operational costs rose in Global Markets, particularly structured derivatives, where the French business invested to support revenue growth. In France, the IT systems inherited with the acquisition of HSBC France were successfully replaced with HSBC's universal banking platform. In Turkey, investment in physical and technical infrastructure and additional headcount in support of business growth also contributed to increased costs.

In **Hong Kong**, operating expenses increased by 16 per cent, compared with growth of 32 per cent in net operating income before loan impairment charges. Staff costs increased by 23 per cent on wage inflation and the recruitment of additional staff to

support business expansion, mainly in Commercial Banking and Global Banking and Markets. Performance-related bonuses increased in response to revenue growth. Increased marketing and IT costs reflected business growth and the launch of new initiatives. As commercial rents rose in Hong Kong's dynamic economy, property rental costs increased, the effect magnified by a sale and leaseback agreement on a headquarters building in 2006.

Operating costs increased by 28 per cent in **Rest of Asia-Pacific** in line with the increase in net operating income before loan impairment charges. Business expansion continued throughout the region. Staff costs in India, mainland China and the Middle East rose on increases in headcount and performance-related bonuses due to higher revenue generation. Business expansion initiatives were taken in mainland China where an additional 27 new branches or sub-branches were opened. In India, branch network, consumer finance and credit card business were expanded. Marketing, technology and infrastructure costs were incurred in support of business expansion.

In **North America**, operating expenses increased by 3 per cent, compared with growth in net operating income before loan impairment charges of 5 per cent. The retail bank branch network was extended both within and beyond the Group's traditional spheres of operation to support the expansion of retail and Commercial Banking businesses. Premises and equipment expenses rose as a consequence. The business incurred US\$70 million of one-off costs arising from the indemnification agreement with Visa ahead of Visa's planned IPO. Communication expenses increased due to higher mailing volumes on cards and consumer lending. In the third quarter, expenditure on card marketing declined in line with a decision to slow lending growth in these portfolios. The consumer finance business incurred restructuring charges resulting from the discontinuation of the wholesale and correspondent channels in mortgage services and the closing of branch offices in consumer lending. There were corresponding benefits in origination costs. In Canada operating expenses rose due to the strategic growth of the bank branch network. Staff numbers and marketing costs increased as new branches were opened and new products were launched. The Canadian consumer finance business was also restructured in

a similar fashion to the US.

Continuing investment and business expansion in **Latin America** resulted in an increase in costs of 15 per cent, compared with growth in net operating income before loan impairment charges of 20 per

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HSBC HOLDINGS PLC

## Report of the Directors: Financial Review

(continued)

### *Operating expenses / Share of profit in associates and joint ventures*

cent. Staff costs rose, mainly on higher salaries and bonuses in the region and one-off costs incurred to improve operational efficiencies in Brazil. These were partially offset by a curtailment and settlement gain from staff transferring from the bank's defined benefit healthcare scheme to a new defined contribution scheme in Mexico. Increases in non-staff costs included higher marketing expenditure, costs relating to growth in credit card operations, higher telecommunication costs and transactional taxes. Four additional months of Banca Nazionale also increased total costs.

Year ended 31 December 2006 compared with year ended 31 December 2005

Operating expenses of US\$33.6 billion were US\$4.0 billion, or 14 per cent, higher than in 2005, and 11 per cent higher on an underlying basis.

The commentary that follows is on an underlying basis.

The main drivers of cost growth were as follows:

- various business expansion initiatives were undertaken during the year. The retail banking operation in the US was enhanced in the form of new branches and improved geographical coverage of Commercial Banking. In the UK, major work was undertaken to refurbish the branch network, improve and increase the number of self-service machines and extend opening hours in certain branches. Across the Rest of the Asia-Pacific region, the branch network expanded, the rollout of the consumer finance business continued, and Commercial Banking's operations were further developed. In Latin America, improvements were made to HSBC's operations in Mexico through the continued expansion of the branch and ATM network;
- the higher costs incurred in Global Banking and Markets reflected the first full year effect of investments made in 2005, together with volume-driven growth in transactional banking and securities services activities and performance-related pay, which rose as revenues grew. The cost efficiency ratio of Global Banking and Markets improved by 40 basis points as net operating income before loan impairment charges grew faster than costs; and
- HSBC's expenditure on marketing continued in order to increase brand awareness, grow market share in key products and support the launch of new products. Notable successes included the online savings product in the US, strong growth in credit card acquisition across the Group, and an innovative new online mortgage product offered in Mexico.

The following points are also of note.

In **Europe**, the cost growth of 9 per cent was concentrated in Personal Financial Services and Global Banking and Markets. In Personal Financial Services, business expansion across the region drove the expenditure. In the UK, costs rose as the branch network refurbishment programme proceeded, additional staff were recruited to support longer opening hours in certain branches and IT costs increased. In France and Turkey, costs rose from the recruitment of additional sales staff and higher marketing expenditure. Costs in Global Banking and Markets increased, reflecting higher performance-related staff costs and the full year effect of the investment in 2005 in

the business, especially in structured derivatives and Global Transaction Banking, where significant revenue growth was seen. These cost increases were partly offset by a reduction in Commercial Banking expenses following the sale of vehicle finance fleet management activities in the UK.

In **Hong Kong**, the increase in operating expenses of 14 per cent was mainly due to higher staff and marketing costs. Additional staff recruited to support longer opening hours in the branch network and the expansion of Commercial Banking, and an increase in revenue-driven performance-related awards drove staff costs higher. Marketing expenditure incurred on advertising and promotional activities rose in support of credit card and investment fund products in Personal Financial Services and the launch of Commercial Banking's global campaign. The full year effect of the enhancement in the second half of 2005 of Global Banking and Markets' business contributed further to the cost growth.

The 27 per cent rise in operating expenses in the **Rest of Asia-Pacific** region was primarily incurred in supporting retail business expansion. Staff costs rose from increased recruitment to support new business initiatives and incentive payments grew in response to improved revenues. Marketing expenses rose as advertising and promotional activity aimed at enlarging HSBC's market share in cards, mortgages and other unsecured lending grew, and Commercial Banking marketing activity across several countries increased. In Global Banking and Markets, cost growth reflected higher revenue-driven performance-related costs and increased expenditure in Global



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Transaction Banking necessitated by business volumes.

In **North America**, costs rose by 13 per cent in 2006. In the US, the increase accompanied the expansion of both the core banking network (by 25 branches) and the geographical presence of Commercial Banking, and arose from incremental costs incurred in support of revenue growth in the consumer finance business. Marketing expenditure also rose, in line with increased levels of activity in the cards businesses in the US, continued promotion of the online savings product and airport branding initiatives. Cost growth in Canada followed higher revenues. The first full year effect of the expansion of various Global Banking and Markets businesses that commenced last year, together with higher

performance-linked pay contributed further to the expense growth.

In **Latin America**, operating expenses rose by 12 per cent. Staff costs grew as additional staff were recruited to support business expansion and pay rises were agreed with the unions. Marketing expenditure was higher as a consequence of advertising campaigns run by Personal Financial Services and Commercial Banking. The continued expansion of the branch network and ATM infrastructure in Mexico, in conjunction with construction of the new headquarters, also contributed to the overall cost growth in the region. Costs rose in Global Banking and Markets in line with higher transactional volumes, increased headcount and union-agreed pay rises.

#### Cost efficiency ratios

	Year ended 31 December		
	2007 %	2006 %	2005 %
<b>HSBC</b>	<b>49.4</b>	51.3	51.2
<b>Personal Financial Services</b>	<b>50.3</b>	49.7	48.7
Europe	<b>64.8</b>	59.2	58.2
Hong Kong	<b>27.2</b>	32.2	33.3
Rest of Asia-Pacific	<b>73.9</b>	71.1	72.3
North America	<b>42.3</b>	42.3	40.8
Latin America	<b>61.3</b>	65.6	64.4
<b>Commercial Banking</b>	<b>44.8</b>	43.7	45.5
Europe	<b>49.3</b>	46.7	49.9
Hong Kong	<b>24.9</b>	26.1	27.2
Rest of Asia-Pacific	<b>42.9</b>	42.5	43.8
North America	<b>45.1</b>	44.9	43.1
Latin America	<b>54.3</b>	55.9	58.2

#### Share of profit in associates and joint ventures

	Year ended 31 December					
	2007 US\$m	%	2006 US\$m	%	2005 US\$m	%
<b>By geographical region</b>						
Europe	<b>95</b>	<b>6.3</b>	(72)	(8.4)	120	18.6

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Hong Kong	<b>28</b>	<b>1.9</b>	19	2.2	23	3.6
Rest of Asia-Pacific	<b>1,348</b>	<b>89.7</b>	865	102.2	453	70.3
North America	<b>20</b>	<b>1.3</b>	30	3.5	48	7.5
Latin America	<b>12</b>	<b>0.8</b>	4	0.5	□	□
	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>
Share of profit in associates and joint ventures	<b>1,503</b>	<b>100.0</b>	846	100.0	644	100.0
	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>

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HSBC HOLDINGS PLC

**Report of the Directors: Financial Review**

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*Share of profit in associates and joint ventures / Asset deployment*

	Year ended 31 December		
	2007 US\$m	2006 US\$m	2005 US\$m
Bank of Communications	445	259	175
Ping An Insurance	518	245	17
Industrial Bank	128	71	46
The Saudi British Bank	216	258	187
Other	159	(10)	121
Share of profit in:			
□ associates	1,466	823	546
□ joint ventures	37	23	98
Share of profit in associates and joint ventures	1,503	846	644

Year ended 31 December 2007 compared with year ended 31 December 2006

Share of profit in associates and joint ventures of US\$1.5 billion was 78 per cent higher than in 2006, on both reported and underlying bases. The commentary that follows is on an underlying basis.

In **Europe**, increased profit resulted from a US\$73 million adjustment to the embedded value of HSBC Assurances, an associate in France, prior to the acquisition of its remaining share capital, following which it was accounted for as a subsidiary.

Profit from associates and joint ventures in the **Rest of Asia-Pacific** region increased by 51 per cent, mainly due to increased contributions from HSBC's strategic investments in mainland China. Profit from Bank of Communications, Ping An Insurance and Industrial Bank improved significantly, driven largely by a thriving local economy.

- HSBC's share of profit from Ping An Insurance rose by 101 per cent to US\$518 million as a result of robust growth, notably from life insurance products and the realisation of synergistic gains across Ping An Insurance's other business offerings.
- Profit from the Bank of Communications rose by 64 per cent to US\$445 million as a result of improved performance across the associate's various product offerings. Increased income from credit and treasury products and significant growth in fee income contributed to the increase in profits.
- HSBC's share of profits from The Saudi British Bank decreased by 22 per cent to US\$216 million. This was largely driven by the effects of a significant correction to the local stock market in the second half of 2006.

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Year ended 31 December 2006 compared with year ended 31 December 2005

Income from associates and joint ventures was US\$846 million, an increase of 31 per cent compared with 2005, and 7 per cent on an underlying basis. The commentary that follows is on an underlying basis.

Improved contributions from The Saudi British Bank, Bank of Communications and Industrial Bank were supplemented by a first full year contribution from Ping An Insurance. These strategic investments are of increasing significance to HSBC's operations in the Rest of Asia-Pacific region. The profits were partly offset by a loss arising from an impairment charge on a private equity investment of an associate in Europe.

- In August 2005, HSBC made an additional investment to increase its stake in Ping An Insurance to 19.9 per cent. The associate reported record results for 2006, with steady growth in the core insurance business complemented by strong investment performance following buoyant stock markets.

During 2006, Ping An Insurance group's nationwide back-office operation in Shanghai became fully functional and the centralisation of the life insurance underwriting and claims business was completed.

- HSBC's share of income from Bank of Communications rose by 44 per cent, driven by wider spreads and an improved product mix, with increased corporate and consumer lending. Fee income also rose as significant progress was made in expanding its investment banking operations.

In 2006, effective risk management and cost control drove operating efficiency with an improvement in the cost efficiency ratio, despite a period of business expansion.

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- During the second half of 2006, HSBC and The Saudi British Bank jointly established HSBC Saudi Arabia Limited, the first full-service independent investment bank in Saudi Arabia licensed under the local new Capital Market law. HSBC, through a wholly owned subsidiary, holds 60 per cent of the equity in the new company and The Saudi British Bank, in which HSBC has a 40 per cent shareholding, holds the remaining 40 per cent.

The share of profits from The Saudi British Bank grew by 21 per cent reflecting a strong performance in all core businesses.

**Asset deployment**

	At 31 December			
	2007 US\$m	%	2006 US\$m	%
Loans and advances to customers	<b>981,548</b>	<b>41.7</b>	868,133	46.6
Loans and advances to banks	<b>237,366</b>	<b>10.1</b>	185,205	10.0
Trading assets	<b>445,968</b>	<b>18.9</b>	328,147	17.6
Financial investments	<b>283,000</b>	<b>12.0</b>	204,806	11.0
Derivatives	<b>187,854</b>	<b>8.0</b>	103,702	5.6
Goodwill and intangible assets	<b>39,689</b>	<b>1.7</b>	37,335	2.0
Other	<b>178,841</b>	<b>7.6</b>	133,430	7.2
	<b>2,354,266</b>	<b>100.0</b>	1,860,758	100.0

Loans and advances to customers include:

□reverse repos	<b>44,898</b>	18,755
□settlement accounts	<b>2,367</b>	3,254

Loans and advances to banks include:

□reverse repos	<b>59,141</b>	45,019
□settlement accounts	<b>2,222</b>	2,028

Year ended 31 December 2007 compared with year ended 31 December 2006

HSBC's total assets at 31 December 2007 were US\$2,354 billion, an increase of US\$494 billion or 27 per cent since 31 December 2006. Over 75 per cent of the increase came from Global Banking and Markets, with the largest contributions from trading assets and derivatives following the strategic decision to expand the collateralised lending, equities and structured derivatives businesses in Europe.

Acquisitions added US\$23 billion to total assets. On an underlying basis, total assets grew by 21 per cent.

The commentary that follows is on an underlying basis.

At 31 December 2007, HSBC's balance sheet was highly liquid. The proportion of assets deployed in loans and advances to customers declined to 42 per cent, while trading assets increased by 32 per cent to US\$446 billion, representing 19 per cent of total assets. The increase in trading assets is discussed below.

Customer advances rose by 9 per cent, due to strong growth in corporate and commercial lending. The largest contribution came from Europe with strong growth in the UK and France.

Growth in residential mortgage lending was subdued, reflecting the decision to slow lending in the US in the light of a deterioration in credit conditions in the personal sector.

#### Trading assets, financial investments and derivatives

Trading assets principally consist of debt and equity instruments acquired for the purpose of market making or to benefit from short-term price movements. Securities classified as held for trading are carried in the balance sheet at fair value, with movements in fair value recognised in the income statement.

Trading assets of US\$446 billion at 31 December 2007 were 32 per cent higher than at 31 December 2006. This increase was mainly due to the growth of the collateralised lending business in Europe. Holdings in debt securities rose as a result of higher trading activity, growth in the structured notes business and increased holdings of shorter maturity assets in the UK. The increase in equity securities resulted from an expansion in the equity swaps business in London, particularly with Asian products, and the growth in trading activity and structured derivatives transactions in France.

Financial investments include debt and equity instruments that are classified as available for sale or,

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HSBC HOLDINGS PLC

**Report of the Directors: Financial Review**

(continued)

*FUM / Assets held under custody / Economic profit*

to a small extent, held to maturity. The available for sale investments essentially represent a core element of the Group's liquidity and may be disposed of either to manage that liquidity or in response to investment opportunities arising from favourable movements in economic indicators, such as interest rates, foreign exchange rates and equity prices. They are carried at fair value with unrealised gains and losses from movements thereon reported in equity until disposal. On disposal the accumulated unrealised gain or loss is recognised through the income statement and reported as "Gains less losses from financial investments".

Financial investments were 29 per cent higher than reported at 31 December 2006, excluding the effect of acquisitions, chiefly HSBC Assurances. This was mainly due to the decision to consolidate Cullinan Finance Ltd ("Cullinan") and Asscher Finance Ltd ("Asscher"), two structured investment vehicles managed by HSBC. The continued growth of HSBC's operations in emerging markets also led to increased holdings of debt securities as surplus funds were invested and more assets were needed to meet regulatory requirements. Net unrealised gains in the valuation of equities amounted to US\$4.2 billion.

Derivatives are financial instruments that derive their value from the price of an underlying item. HSBC transacts derivatives for three primary purposes: to create risk management solutions for clients, for proprietary trading purposes, and to manage and hedge HSBC's own risks.

Derivative assets rose by 73 per cent, due to increases in interest rate swap balances, primarily in the UK and France. Credit derivative assets increased, particularly in the US in the first half of the year, followed by a significant slowdown in client trading in the second half of the year due to the deterioration in credit markets. Foreign exchange derivative balances increased, driven by heightened volatility in major currencies, particularly the US dollar.

**Funds under management**

	<b>2007</b>	2006
	<b>US\$bn</b>	US\$bn
<b>Funds under management</b>		
At 1 January	<b>695</b>	561
Net new money	<b>36</b>	44
Value change	<b>53</b>	57
Exchange and other	<b>60</b>	33
	<hr/>	<hr/>
At 31 December	<b>844</b>	695
	<hr/>	<hr/>
		Year ended 31 December
	<hr/>	<hr/>
	<b>2007</b>	2006
	<b>US\$bn</b>	US\$bn
<b>Funds under management by business</b>		
HSBC Global Asset Management	<b>380</b>	328
Private Banking	<b>275</b>	232
Affiliates	<b>3</b>	2
Other	<b>186</b>	133

<b>844</b>	695
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Funds under management at 31 December 2007 were US\$844 billion, an increase of US\$149 billion, or 21 per cent, compared with 31 December 2006. Both HSBC Global Asset Management and Private Banking delivered good investment performance and continued to attract new funds with net new money of US\$36 billion.

HSBC Global Asset Management funds reached US\$380 billion, a rise of 16 per cent compared with 2006. This was attributable to US\$12 billion of net new money, strong investment performance and favourable foreign exchange movements. Emerging markets contributed significantly to overall growth, with funds reaching US\$93 billion, placing HSBC Global Asset Management as one of the world's largest emerging market asset managers.

Private Banking's funds increased by 19 per cent to US\$275 billion, driven by client acquisition, partly due to greater brand awareness and an enhanced product range, strong investment performance and foreign exchange movements.

Client assets, which provide an indicator of overall Private Banking volumes and include funds under management, grew by 26 per cent, reaching US\$421 billion.

Other funds under management, of which the main element is a corporate trust business in Asia, increased by 40 per cent to US\$186 billion, driven by increases in the property trust business .

#### Assets held in custody and under administration

At 31 December 2007, assets held by HSBC as custodian amounted to US\$6,094 billion, 33 per cent higher than the US\$4,572 billion held at 31 December 2006. At constant exchange rates, growth was 30 per cent.

Complementing this was HSBC's assets under administration business. At 31 December 2007, the value of assets held under administration by the Group amounted to US\$1,422 billion, 24 per cent higher than the US\$1,150 billion held at 31 December 2006. At constant exchange rates, growth was 19 per cent.



[Back to Contents](#)**Economic profit**

HSBC's internal performance measures include economic profit, a calculation which compares the return on financial capital invested in HSBC by its shareholders with the cost of that capital. HSBC prices its cost of capital internally and the difference between that cost and profit attributable to ordinary shareholders of the parent company, represents the amount of economic profit generated. Economic profit is used by management as a means of deciding where to allocate resources so that they will be most productive.

In order to concentrate on external factors rather than measurement bases, HSBC emphasises the trend in economic profit within business units rather than absolute amounts. In light of the current levels of world interest rates, and taking into account its geographical and customer group diversification, HSBC believes that its true cost of capital on a

consolidated basis remains 10 per cent. HSBC plans to continue using this rate until the end of the current five-year strategic plan in 2008 in order to ensure consistency and comparability.

Economic profit increased by US\$1.4 billion, or 27 per cent compared with 2006. This increase compared favourably with the decrease recorded in 2006. Growth in Asia was partially offset by loan impairment charges, mainly in the US business. This led to a geographical realignment of profitability which had a positive effect on economic profit as, in general, Asia has lower tax rates than the US. Economic profit was also affected by significant fair value movements on HSBC's own debt as a result of widening credit spreads and related derivatives. This resulted in a higher return on average invested capital and, in consequence, economic spread, which increased by 0.4 percentage points compared with 2006.

	Year ended 31 December			
	2007		2006	
	US\$m	% <sup>1</sup>	US\$m	% <sup>1</sup>
Average total shareholders' equity	120,346		100,860	
Adjusted by:				
Goodwill previously amortised or written off	8,172		8,172	
Property revaluation reserves	(898)		(1,062)	
Reserves representing unrealised (gains)/losses on effective cash flow hedges	425		(126)	
Reserves representing unrealised gains on available-for-sale securities	(1,918)		(1,156)	
Preference shares	(1,405)		(1,405)	
Average invested capital <sup>2</sup>	124,722		105,283	
Return on invested capital <sup>3</sup>	19,043	15.3	15,699	14.9
Benchmark cost of capital	(12,472)	(10.0)	(10,528)	(10.0)
Economic profit/spread	6,571	5.3	5,171	4.9

1 Expressed as a percentage of average invested capital.

2 Average invested capital is measured as average total shareholders' equity after:

□

*adding back the average balance of goodwill impaired or amortised pre-transition to IFRSs or subsequently written-off, directly to reserves;*

- deducting the average balance of HSBC's revaluation surplus relating to property held for own use. This reserve was generated when determining the deemed carrying cost of such properties on transition to IFRSs and will run down over time as the properties are sold;*
  - deducting average preference shares issued by HSBC Holdings, and;*
  - deducting average reserves for unrealised gains/(losses) on effective cash flow hedges and available-for-sale securities.*
- 3 *Return on invested capital is based on the profit attributable to ordinary shareholders of the parent company.*

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HSBC HOLDINGS PLC

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*Other financial information > Average balance sheet***Other financial information****Average balance sheet and net interest income**

Average balances and related interest are shown for the domestic operations of HSBC's principal commercial banks by geographic region. "Other operations" comprise the operations of the principal commercial banking and consumer finance entities outside their domestic markets and all other banking operations, including investment banking balances and transactions.

Average balances are based on daily averages for the principal areas of HSBC's banking activities with monthly or less frequent averages used elsewhere.

Balances and transactions with fellow subsidiaries are reported gross in the principal commercial banking and consumer finance entities within "Other interest-earning assets" and "Other interest-bearing liabilities" as appropriate and the elimination entries are included within "Other operations" in those two categories.

Net interest margin numbers are calculated by dividing net interest income as reported in the income statement by the average interest-earning assets from which interest income is reported within the "Net interest income" line of the income statement. Interest income and interest expense arising from trading assets and liabilities and the funding thereof is included within "Net trading income" in the income statement.

## Assets

	Year ended 31 December								
	2007			2006			2005		
	Average balance US\$m	Interest income US\$m	Yield %	Average balance US\$m	Interest income US\$m	Yield %	Average balance US\$m	Interest income US\$m	Yield %
<b>Summary</b>									
Total interest-earning assets (itemised below)	<b>1,296,701</b>	<b>92,359</b>	<b>7.12</b>	1,113,404	75,879	6.82	999,421	60,094	6.01
Trading assets <sup>1</sup>	<b>374,973</b>	<b>17,562</b>	<b>4.68</b>	288,605	12,445	4.31	292,404	7,232	2.47
Financial assets designated at fair value <sup>2</sup>	<b>14,899</b>	<b>813</b>	<b>5.46</b>	7,681	290	3.78	15,247	405	2.66
Impairment provisions	<b>(15,309)</b>			(11,864)			(12,469)		
Non-interest-earning assets	<b>440,686</b>			291,741			207,337		

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Total assets and interest income		<b>2,111,950</b>	<b>110,734</b>	<b>5.24</b>	1,689,567	88,614	5.24	1,501,940	67,731	4.51
<b>Short-term funds and loans and advances to banks</b>										
Europe	HSBC Bank	<b>49,910</b>	<b>2,592</b>	<b>5.19</b>	33,856	1,536	4.54	21,875	774	3.54
	HSBC Private Banking Holdings (Suisse)	<b>5,295</b>	<b>229</b>	<b>4.32</b>	4,956	190	3.83	3,606	113	3.13
	HSBC France	<b>31,591</b>	<b>1,294</b>	<b>4.10</b>	20,197	690	3.42	16,829	387	2.30
Hong Kong	Hang Seng Bank	<b>13,054</b>	<b>609</b>	<b>4.67</b>	10,360	483	4.66	8,061	288	3.57
	The Hongkong and Shanghai Banking Corporation	<b>50,210</b>	<b>2,352</b>	<b>4.68</b>	38,802	1,645	4.24	36,904	1,058	2.87
	The Hongkong and Shanghai Banking Corporation	<b>19,286</b>	<b>810</b>	<b>4.20</b>	13,388	520	3.88	11,667	351	3.01
Rest of Asia-Pacific	HSBC Bank Malaysia	<b>2,861</b>	<b>103</b>	<b>3.60</b>	2,492	87	3.49	1,767	49	2.77
	HSBC Bank Middle East	<b>6,328</b>	<b>324</b>	<b>5.12</b>	4,279	208	4.86	3,262	111	3.40
North America	HSBC Bank USA	<b>9,393</b>	<b>477</b>	<b>5.08</b>	8,422	465	5.52	3,579	151	4.22
	HSBC Bank Canada	<b>3,810</b>	<b>174</b>	<b>4.57</b>	3,167	138	4.36	2,115	62	2.93
Latin America	HSBC Mexico	<b>3,555</b>	<b>239</b>	<b>6.72</b>	3,395	227	6.69	2,994	228	7.62
	Brazilian operations <sup>3</sup>	<b>5,790</b>	<b>645</b>	<b>11.14</b>	4,129	572	13.85	3,305	565	17.10
	HSBC Bank Panama	<b>897</b>	<b>33</b>	<b>3.68</b>	130	9	6.92	69	3	4.35
	HSBC Bank Argentina	<b>304</b>	<b>16</b>	<b>5.26</b>	196	8	4.08	264	7	2.65
Other operations		<b>19,087</b>	<b>898</b>	<b>4.70</b>	16,686	618	3.70	14,954	453	3.03
		<b>221,371</b>	<b>10,795</b>	<b>4.88</b>	164,455	7,396	4.50	131,251	4,600	3.50

For footnotes, see page 173.

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(continued)

Year ended 31 December

		2007			2006			2005		
		Average balance US\$m	Interest income US\$m	Yield %	Average balance US\$m	Interest income US\$m	Yield %	Average balance US\$m	Interest income US\$m	Yield %
<b>Loans and advances to customers</b>										
Europe	HSBC Bank	<b>237,231</b>	<b>18,078</b>	<b>7.62</b>	226,528	14,166	6.25	203,568	12,223	6.00
	HSBC Private Banking Holdings (Suisse)	<b>9,805</b>	<b>507</b>	<b>5.17</b>	7,134	338	4.74	5,795	211	3.64
	HSBC France	<b>68,027</b>	<b>3,219</b>	<b>4.73</b>	52,990	2,463	4.65	41,977	1,710	4.07
	HSBC Finance	<b>5,492</b>	<b>611</b>	<b>11.13</b>	5,932	671	11.31	9,951	1,086	10.91
Hong Kong	Hang Seng Bank	<b>37,827</b>	<b>2,120</b>	<b>5.60</b>	34,416	1,952	5.67	32,893	1,323	4.02
	The Hongkong and Shanghai Banking Corporation	<b>48,134</b>	<b>2,901</b>	<b>6.03</b>	47,292	2,843	6.01	43,971	2,061	4.69
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	<b>59,286</b>	<b>4,321</b>	<b>7.29</b>	52,159	3,449	6.61	46,652	2,659	5.70
	HSBC Bank Malaysia	<b>7,467</b>	<b>507</b>	<b>6.79</b>	6,292	430	6.83	5,380	325	6.04
	HSBC Bank Middle East	<b>15,125</b>	<b>1,200</b>	<b>7.93</b>	12,757	957	7.50	10,038	635	6.33
North America	HSBC Bank USA	<b>90,091</b>	<b>6,585</b>	<b>7.31</b>	88,563	6,141	6.93	86,800	5,594	6.44
	HSBC Finance	<b>153,658</b>	<b>18,086</b>	<b>11.77</b>	147,336	17,061	11.58	118,215	13,307	11.26
	HSBC Bank Canada	<b>43,570</b>	<b>2,598</b>	<b>5.96</b>	35,055	2,037	5.81	28,491	1,439	5.05
Latin America	HSBC Mexico	<b>16,469</b>	<b>2,187</b>	<b>13.28</b>	13,193	1,532	11.61	9,983	1,210	12.12
	Brazilian operations <sup>3</sup>	<b>13,569</b>	<b>3,895</b>	<b>28.71</b>	9,461	3,244	34.29	7,447	2,647	35.54
	HSBC Bank Panama	<b>8,113</b>	<b>778</b>	<b>9.59</b>	1,189	92	7.74	990	67	6.77
	HSBC Bank Argentina	<b>1,667</b>	<b>241</b>	<b>14.46</b>	838	107	12.77	914	122	13.35
Other operations		<b>21,318</b>	<b>1,790</b>	<b>8.40</b>	19,795	1,528	7.72	26,213	1,285	4.90
		<b>836,849</b>	<b>69,624</b>	<b>8.32</b>	760,930	59,011	7.76	679,278	47,904	7.05
<b>Financial investments</b>										
Europe	HSBC Bank	<b>45,885</b>	<b>2,431</b>	<b>5.30</b>	42,726	1,977	4.63	35,787	1,297	3.62
	HSBC Private Banking Holdings (Suisse)	<b>10,372</b>	<b>511</b>	<b>4.93</b>	8,729	391	4.48	8,725	342	3.92

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	HSBC France	<b>10,357</b>	<b>511</b>	<b>4.93</b>	2,545	95	3.73	4,482	143	3.19
Hong Kong	Hang Seng Bank	<b>30,791</b>	<b>1,550</b>	<b>5.03</b>	27,288	1,224	4.49	23,445	815	3.48
	The Hongkong and Shanghai Banking Corporation	<b>20,717</b>	<b>1,017</b>	<b>4.91</b>	20,362	911	4.47	29,508	924	3.13
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	<b>23,739</b>	<b>1,065</b>	<b>4.49</b>	17,179	737	4.29	15,100	592	3.92
	HSBC Bank Malaysia	<b>1,515</b>	<b>56</b>	<b>3.70</b>	954	36	3.77	1,182	41	3.47
North America	HSBC Bank Middle East	<b>3,654</b>	<b>174</b>	<b>4.76</b>	1,387	72	5.19	1,311	44	3.36
	HSBC Bank USA	<b>23,373</b>	<b>1,189</b>	<b>5.09</b>	22,214	1,109	4.99	19,262	864	4.49
	HSBC Finance Canada	<b>4,072</b>	<b>229</b>	<b>5.62</b>	3,724	200	5.37	3,945	221	5.60
Latin America	HSBC Bank Canada	<b>6,068</b>	<b>258</b>	<b>4.25</b>	4,351	174	4.00	3,951	116	2.94
	HSBC Mexico	<b>3,327</b>	<b>319</b>	<b>9.59</b>	4,049	427	10.55	4,995	583	11.67
	Brazilian operations <sup>3</sup>	<b>5,596</b>	<b>672</b>	<b>12.01</b>	3,862	501	12.97	2,328	324	13.92
Other operations	HSBC Bank Panama	<b>709</b>	<b>58</b>	<b>8.18</b>	429	21	4.90	92	5	5.43
	HSBC Bank Argentina	<b>563</b>	<b>68</b>	<b>12.08</b>	311	38	12.22	218	23	10.55
		<b>27,252</b>	<b>1,407</b>	<b>5.16</b>	24,742	1,191	4.81	17,677	876	4.96
	<b>217,990</b>	<b>11,515</b>	<b>5.28</b>	184,852	9,104	4.93	172,008	7,210	4.19	

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HSBC HOLDINGS PLC

**Report of the Directors: Financial Review**

(continued)

*Other financial information > Average balance sheet*Assets  
(continued)

		Year ended 31 December								
		2007			2006			2005		
		Average balance US\$m	Interest income US\$m	Yield %	Average balance US\$m	Interest income US\$m	Yield %	Average balance US\$m	Interest income US\$m	Yield %
<b>Other interest-earning assets</b>										
Europe	HSBC Bank	11,170	652	5.84	9,938	652	6.56	14,748	543	3.68
	HSBC Private Banking Holdings (Suisse)	16,360	882	5.39	14,558	732	5.03	11,831	416	3.52
	HSBC France	12,158	419	3.45	6,434	173	2.69	9,811	442	4.51
Hong Kong	Hang Seng Bank	832	42	5.05	538	28	5.20	81	3	3.70
	The Hongkong and Shanghai Banking Corporation	27,057	1,237	4.57	19,246	909	4.72	18,310	443	2.42
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	11,137	588	5.28	6,938	449	6.47	4,836	200	4.14
	HSBC Bank Malaysia	231	12	5.19	178	10	5.62	283	8	2.83
	HSBC Bank Middle East	758	52	6.86	380	32	8.42	371	18	4.85
North America	HSBC Bank USA	3,731	231	6.19	1,867	82	4.39	1,444	43	2.98
	HSBC Finance	1,724	89	5.16	767	43	5.61	2,063	67	3.25
	HSBC Bank Canada	960	31	3.23	1,006	32	3.18	641	18	2.80
Latin America	HSBC Mexico	□	□	□	□	□	□	1,186	16	1.35
	Brazilian operations <sup>3</sup>	840	75	8.93	1,004	190	18.92	558	162	29.00
	HSBC Bank Panama	1,351	40	2.96	□	□	□	116	4	3.45
	HSBC Bank Argentina	39	1	2.56	23	3	13.04	43	2	4.65
Other operations		(67,857)	(3,926)		(59,710)	(2,967)		(49,438)	(2,005)	
		<b>20,491</b>	<b>425</b>	<b>2.07</b>	<b>3,167</b>	<b>368</b>	<b>11.62</b>	<b>16,884</b>	<b>380</b>	<b>2.25</b>
<b>Total interest-earning assets</b>										
Europe	HSBC Bank	344,196	23,753	6.90	313,048	18,331	5.86	275,978	14,837	5.38

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	HSBC Private Banking Holdings (Suisse)	<b>41,832</b>	<b>2,129</b>	<b>5.09</b>	35,377	1,651	4.67	29,957	1,082	3.6
	HSBC France	<b>122,133</b>	<b>5,443</b>	<b>4.46</b>	82,166	3,421	4.16	73,099	2,682	3.6
	HSBC Finance	<b>5,492</b>	<b>611</b>	<b>11.13</b>	5,932	671	11.31	9,951	1,086	10.9
Hong Kong	Hang Seng Bank	<b>82,504</b>	<b>4,321</b>	<b>5.24</b>	72,602	3,687	5.08	64,480	2,429	3.7
	The Hongkong and Shanghai Banking Corporation	<b>146,118</b>	<b>7,507</b>	<b>5.14</b>	125,702	6,308	5.02	128,693	4,486	3.4
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	<b>113,448</b>	<b>6,784</b>	<b>5.98</b>	89,664	5,155	5.75	78,255	3,802	4.8
	HSBC Bank Malaysia	<b>12,074</b>	<b>678</b>	<b>5.62</b>	9,916	563	5.68	8,612	423	4.9
	HSBC Bank Middle East	<b>25,865</b>	<b>1,750</b>	<b>6.77</b>	18,803	1,269	6.75	14,982	808	5.3
North America	HSBC Bank USA	<b>126,588</b>	<b>8,482</b>	<b>6.70</b>	121,066	7,797	6.44	111,085	6,652	5.9
	HSBC Finance	<b>159,454</b>	<b>18,404</b>	<b>11.54</b>	151,827	17,304	11.40	124,223	13,595	10.9
	HSBC Bank Canada	<b>54,408</b>	<b>3,061</b>	<b>5.63</b>	43,579	2,381	5.46	35,198	1,635	4.6
Latin America	HSBC Mexico	<b>23,351</b>	<b>2,745</b>	<b>11.76</b>	20,637	2,186	10.59	19,158	2,037	10.6
	Brazilian operations <sup>3</sup>	<b>25,795</b>	<b>5,287</b>	<b>20.50</b>	18,456	4,507	24.42	13,638	3,698	27.1
	HSBC Bank Panama	<b>11,070</b>	<b>909</b>	<b>8.21</b>	1,748	122	6.98	1,267	79	6.2
	HSBC Bank Argentina	<b>2,573</b>	<b>326</b>	<b>12.67</b>	1,368	156	11.40	1,439	154	10.7
Other operations		<b>(200)</b>	<b>169</b>		1,513	370		9,406	609	
		<b>1,296,701</b>	<b>92,359</b>	<b>7.12</b>	1,113,404	75,879	6.82	999,421	60,094	6.0

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## Total equity and liabilities

Year ended 31 December

	Year ended 31 December								
	2007			2006			2005		
	Average balance US\$m	Interest expense US\$m	Cost %	Average balance US\$m	Interest expense US\$m	Cost %	Average balance US\$m	Interest expense US\$m	Cost %
<b>Summary</b>									
Total interest-bearing liabilities (itemised below)	<b>1,279,460</b>	<b>54,564</b>	<b>4.26</b>	1,067,646	41,393	3.88	920,095	28,760	3.13
Trading liabilities	<b>250,572</b>	<b>12,186</b>	<b>4.86</b>	224,050	9,842	4.39	211,059	5,024	2.38
Financial liabilities designated at fair value (excluding own debt issued)	<b>20,827</b>			12,537			9,787		
Non-interest-bearing current accounts	<b>83,958</b>			71,744			65,509		
Total equity and other non-interest-bearing liabilities	<b>477,133</b>			313,590			295,490		
<b>Total equity and liabilities</b>	<b>2,111,950</b>	<b>66,750</b>	<b>3.16</b>	1,689,567	51,235	3.03	1,501,940	33,784	2.25

**Deposits by banks<sup>4</sup>**

Europe	HSBC Bank	<b>44,787</b>	<b>2,148</b>	<b>4.80</b>	32,825	1,311	3.99	32,673	1,037	3.17
	HSBC Private Banking Holdings (Suisse)	<b>690</b>	<b>22</b>	<b>3.19</b>	1,030	33	3.20	886	20	2.26
	HSBC France	<b>30,816</b>	<b>1,358</b>	<b>4.41</b>	23,171	886	3.82	17,935	582	3.25
Hong Kong	Hang Seng Bank	<b>2,993</b>	<b>123</b>	<b>4.11</b>	2,031	84	4.14	1,876	61	3.25
	The Hongkong and Shanghai Banking Corporation	<b>3,634</b>	<b>150</b>	<b>4.13</b>	2,745	125	4.55	3,430	116	3.38
	The Hongkong and Shanghai Banking Corporation	<b>10,247</b>	<b>445</b>	<b>4.34</b>	6,276	246	3.92	4,973	168	3.38
Rest of Asia-Pacific	HSBC Bank Malaysia	<b>375</b>	<b>12</b>	<b>3.20</b>	280	9	3.21	238	5	2.10
	HSBC Bank Middle East	<b>672</b>	<b>32</b>	<b>4.76</b>	453	23	5.08	888	27	3.04
North America	HSBC Bank USA	<b>6,933</b>	<b>414</b>	<b>5.97</b>	3,695	208	5.63	4,251	202	4.75
	HSBC Bank Canada	<b>1,681</b>	<b>93</b>	<b>5.53</b>	1,520	68	4.47	926	34	3.67

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Latin America	HSBC Mexico	983	63	6.41	781	50	6.40	1,051	70	6.66
	Brazilian operations <sup>3</sup>	1,549	106	6.84	1,033	101	9.78	1,355	125	9.23
	HSBC Bank Panama	1,137	66	5.80	349	17	4.87	218	7	3.21
	HSBC Bank Argentina	117	9	7.69	72	5	6.94	111	8	7.21
Other operations		4,495	291	6.47	5,304	334	6.30	3,744	204	5.45
		<b>111,109</b>	<b>5,332</b>	<b>4.80</b>	81,565	3,500	4.29	74,555	2,666	3.58

**Financial liabilities designated at fair value**  
 own debt issued

Europe	HSBC Holdings	15,142	822	5.43	15,132	745	4.92	13,928	496	3.56
	HSBC Bank	9,907	525	5.30	7,888	373	4.73	5,919	327	5.52
	HSBC France	143	11	7.69						
	Hang Seng Bank	126	6	4.76						
Hong Kong	HSBC Bank									
North America	USA	1,620	125	7.72	1,892	116	6.13	1,469	96	6.54
	HSBC Finance	31,889	2,079	6.52	29,917	1,877	6.27	28,146	1,098	3.90
Other operations					461	49	10.63	288	20	6.94
		<b>58,827</b>	<b>3,568</b>	<b>6.07</b>	55,290	3,160	5.72	49,750	2,037	4.09

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**Report of the Directors: Financial Review**

(continued)

*Other financial information > Average balance sheet*Total equity and liabilities  
(continued)

		Year ended 31 December								
		2007			2006			2005		
		Average balance US\$m	Interest expense US\$m	Cost %	Average balance US\$m	Interest expense US\$m	Cost %	Average balance US\$m	Interest expense US\$m	Cost %
<b>Customer accounts<sup>5</sup></b>										
Europe	HSBC Bank	<b>270,965</b>	<b>10,576</b>	<b>3.90</b>	221,369	7,031	3.18	186,996	5,359	2.87
	HSBC Private Banking Holdings (Suisse)	<b>30,955</b>	<b>1,485</b>	<b>4.80</b>	25,346	1,069	4.22	19,908	622	3.12
	HSBC France	<b>31,845</b>	<b>1,226</b>	<b>3.85</b>	23,579	752	3.19	24,538	611	2.49
Hong Kong	Hang Seng Bank	<b>61,227</b>	<b>1,900</b>	<b>3.10</b>	54,267	1,712	3.15	51,460	874	1.70
	The Hongkong and Shanghai Banking Corporation	<b>125,478</b>	<b>3,499</b>	<b>2.79</b>	104,441	2,934	2.81	95,496	1,322	1.38
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	<b>76,052</b>	<b>2,645</b>	<b>3.48</b>	56,760	1,903	3.35	48,997	1,293	2.64
	HSBC Bank Malaysia	<b>8,823</b>	<b>260</b>	<b>2.95</b>	7,260	212	2.92	6,123	157	2.56
	HSBC Bank Middle East	<b>15,685</b>	<b>578</b>	<b>3.69</b>	11,713	411	3.51	8,696	207	2.38
North America	HSBC Bank USA	<b>78,138</b>	<b>3,051</b>	<b>3.90</b>	71,031	2,490	3.51	60,795	1,385	2.28
	HSBC Bank Canada	<b>30,060</b>	<b>1,090</b>	<b>3.63</b>	25,277	804	3.18	21,635	475	2.20
Latin America	HSBC Mexico	<b>14,230</b>	<b>548</b>	<b>3.85</b>	13,625	471	3.46	8,272	188	2.27
	Brazilian operations <sup>3</sup>	<b>19,581</b>	<b>2,163</b>	<b>11.05</b>	14,887	2,056	13.81	10,790	1,859	17.23
	HSBC Bank Panama	<b>7,604</b>	<b>314</b>	<b>4.13</b>	998	34	3.41	736	17	2.31
	HSBC Bank Argentina	<b>1,892</b>	<b>85</b>	<b>4.49</b>	983	41	4.17	903	28	3.10
Other operations		<b>55,351</b>	<b>2,297</b>	<b>4.15</b>	49,846	1,811	3.63	44,080	1,256	2.85

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		<b>827,886</b>	<b>31,717</b>	<b>3.83</b>	681,382	23,731	3.48	589,425	15,653	2.66
<b>Debt securities in issue</b>										
Europe	HSBC Bank	<b>64,168</b>	<b>3,753</b>	<b>5.85</b>	45,870	2,047	4.46	28,620	1,817	6.35
	HSBC France	<b>28,757</b>	<b>1,207</b>	<b>4.20</b>	19,818	633	3.19	14,271	314	2.20
	HSBC Finance Hang Seng	<b>240</b>	<b>18</b>	<b>7.50</b>	548	32	5.84	3,330	77	2.31
Hong Kong	Bank	<b>1,734</b>	<b>80</b>	<b>4.61</b>	1,622	64	3.95	1,523	53	3.48
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	<b>8,979</b>	<b>559</b>	<b>6.23</b>	7,990	438	5.48	6,523	315	4.83
	HSBC Bank Malaysia	<b>318</b>	<b>13</b>	<b>4.09</b>	371	13	3.50	572	16	2.80
	HSBC Bank Middle East	<b>2,086</b>	<b>119</b>	<b>5.70</b>	□	□	□	□	□	□
North America	HSBC Bank USA	<b>25,724</b>	<b>1,232</b>	<b>4.79</b>	28,832	1,407	4.88	25,537	1,073	4.20
	HSBC Finance	<b>115,520</b>	<b>5,311</b>	<b>4.60</b>	112,353	5,047	4.49	75,913	3,399	4.48
	HSBC Bank Canada	<b>14,771</b>	<b>640</b>	<b>4.33</b>	10,616	460	4.33	7,963	268	3.37
Latin America	HSBC Mexico	<b>1,147</b>	<b>110</b>	<b>9.59</b>	249	23	9.24	4,585	285	6.22
	Brazilian operations <sup>3</sup>	<b>1,417</b>	<b>115</b>	<b>8.12</b>	700	70	10.00	401	67	16.71
	HSBC Bank Panama	<b>607</b>	<b>45</b>	<b>7.41</b>	35	2	5.71	□	□	□
	HSBC Bank Argentina	<b>12</b>	□	□	□	□	□	7	1	14.29
Other operations		<b>6,446</b>	<b>(13)</b>	<b>(0.20)</b>	3,070	108	3.52	6,834	90	1.32
		<b>271,926</b>	<b>13,189</b>	<b>4.85</b>	232,074	10,344	4.46	176,079	7,775	4.42

For footnotes, see page 173.

[Back to Contents](#)Total equity and  
liabilities (*continued*)

Year ended 31 December

		2007			2006			2005		
		Average balance US\$m	Interest expense US\$m	Cost %	Average balance US\$m	Interest expense US\$m	Cost %	Average balance US\$m	Interest expense US\$m	Cost %
<b>Other interest-bearing liabilities</b>										
Europe	HSBC Bank	22,035	1,302	5.91	23,196	1,026	4.42	23,924	547	2.29
	HSBC Private Banking Holdings (Suisse)	3,427	163	4.76	3,545	155	4.37	4,247	130	3.06
	HSBC France	27,830	979	3.52	13,476	488	3.62	14,154	220	1.55
	HSBC Finance	4,557	227	4.98	4,211	219	5.20	5,299	361	6.81
Hong Kong	Hang Seng Bank	2,278	114	5.00	1,378	64	4.64	1,228	36	2.93
	The Hongkong and Shanghai Banking Corporation	9,866	535	5.42	8,140	365	4.48	6,981	221	3.17
	The Hongkong and Shanghai Banking Corporation	12,631	580	4.59	13,425	629	4.69	13,725	460	3.35
Rest of Asia-Pacific	HSBC Bank Malaysia	232	6	2.59	235	9	3.83	137	4	2.92
	HSBC Bank Middle East	1,168	81	6.93	1,046	63	6.02	767	23	3.00
North America	HSBC Bank USA	13,602	587	4.32	11,966	1,211	10.12	13,287	1,332	10.02
	HSBC Finance	1,941	113	5.82	542	18	3.32	□	□	□
	HSBC Bank Canada	1,151	27	2.35	1,134	22	1.94	856	12	1.40
	HSBC Markets Inc	8,889	255	2.87	2,883	88	3.05	4,718	121	2.56
Latin America	HSBC Mexico	207	16	7.73	135	8	5.93	1,258	30	2.38
	Brazilian operations <sup>3</sup>	1,103	182	16.50	817	105	12.85	2,264	86	3.80
	HSBC Bank Panama	574	9	1.57	□	□	□	69	3	4.35
	HSBC Bank Argentina	95	4	4.21	79	10	12.66	35	4	11.43
Other operations		(101,874)	(4,422)		(68,873)	(3,822)		(62,662)	(2,961)	

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		<b>9,712</b>	<b>758</b>	<b>7.80</b>	17,335	658	3.80	30,287	629	2.08
<b>Total interest-bearing liabilities</b>										
Europe	HSBC Bank	<b>411,862</b>	<b>18,304</b>	<b>4.44</b>	331,148	11,788	3.56	278,131	9,087	3.27
	HSBC Private Banking Holdings (Suisse)	<b>35,072</b>	<b>1,670</b>	<b>4.76</b>	29,921	1,257	4.20	25,041	772	3.08
	HSBC France	<b>119,391</b>	<b>4,781</b>	<b>4.00</b>	80,044	2,759	3.45	70,898	1,727	2.44
	HSBC Finance	<b>4,797</b>	<b>245</b>	<b>5.11</b>	4,759	251	5.27	8,629	438	5.08
Hong Kong	Hang Seng Bank	<b>68,358</b>	<b>2,223</b>	<b>3.25</b>	59,298	1,924	3.24	56,087	1,024	1.83
	The Hongkong and Shanghai Banking Corporation	<b>138,978</b>	<b>4,184</b>	<b>3.01</b>	115,326	3,424	2.97	105,907	1,659	1.57
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	<b>107,909</b>	<b>4,229</b>	<b>3.92</b>	84,451	3,216	3.81	74,218	2,236	3.01
	HSBC Bank Malaysia	<b>9,748</b>	<b>291</b>	<b>2.99</b>	8,146	243	2.98	7,070	182	2.57
	HSBC Bank Middle East	<b>19,611</b>	<b>810</b>	<b>4.13</b>	13,212	497	3.76	10,351	257	2.48
North America	HSBC Bank USA	<b>126,017</b>	<b>5,409</b>	<b>4.29</b>	117,416	5,432	4.63	105,339	4,088	3.88
	HSBC Finance	<b>149,350</b>	<b>7,503</b>	<b>5.02</b>	142,812	6,942	4.86	104,059	4,497	4.32
	HSBC Bank Canada	<b>47,663</b>	<b>1,850</b>	<b>3.88</b>	38,547	1,354	3.51	31,380	789	2.51
	HSBC Markets Inc	<b>8,889</b>	<b>255</b>	<b>2.87</b>	2,883	88	3.05	4,718	121	2.56
Latin America	HSBC Mexico	<b>16,567</b>	<b>737</b>	<b>4.45</b>	14,790	552	3.73	15,166	573	3.78
	Brazilian operations <sup>3</sup>	<b>23,650</b>	<b>2,566</b>	<b>10.85</b>	17,437	2,332	13.37	14,810	2,137	14.43
	HSBC Bank Panama	<b>9,922</b>	<b>434</b>	<b>4.37</b>	1,383	53	3.83	1,023	27	2.64
	HSBC Bank Argentina	<b>2,116</b>	<b>98</b>	<b>4.63</b>	1,134	56	4.94	1,056	41	3.88
Other operations		<b>(20,440)</b>	<b>(1,025)</b>		4,939	(775)		6,212	(895)	
		<b>1,279,460</b>	<b>54,564</b>	<b>4.26</b>	1,067,646	41,393	3.88	920,095	28,760	3.13

For footnotes, see page 173.



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**Report of the Directors: Financial Review**

(continued)

*Other financial information > Average balance sheet / Analysis of changes in net interest income*

Net interest margin

		Year ended 31 December		
		2007	2006	2005
		%	%	%
Europe	HSBC Bank	<b>1.58</b>	2.09	2.08
	HSBC Private Banking Holdings (Suisse)	<b>1.10</b>	1.11	1.03
	HSBC France	<b>0.54</b>	0.81	1.31
	HSBC Finance	<b>6.66</b>	7.08	6.51
Hong Kong	Hang Seng Bank	<b>2.54</b>	2.43	2.18
	The Hongkong and Shanghai Banking Corporation	<b>2.27</b>	2.29	2.20
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	<b>2.25</b>	2.16	2.00
	HSBC Bank Malaysia	<b>3.21</b>	3.23	2.80
	HSBC Bank Middle East	<b>3.63</b>	4.11	3.68
North America	HSBC Bank USA	<b>2.43</b>	1.95	2.31
	HSBC Finance	<b>6.84</b>	6.83	7.32
	HSBC Bank Canada	<b>2.23</b>	2.36	2.40
Latin America	HSBC Mexico	<b>8.60</b>	7.92	7.64
	Brazilian operations <sup>3</sup>	<b>10.55</b>	11.78	11.45
	HSBC Bank Panama	<b>4.29</b>	3.94	4.10
	HSBC Bank Argentina	<b>8.86</b>	7.31	7.85
		<b>2.91</b>	3.10	3.14

Distribution of average total assets

Europe	HSBC Bank	<b>34.6</b>	30.6	30.1
	HSBC Private Banking Holdings (Suisse)	<b>2.2</b>	2.3	2.2
	HSBC France	<b>12.0</b>	10.0	9.9
	HSBC Finance	<b>0.3</b>	0.5	0.7
Hong Kong	Hang Seng Bank	<b>4.4</b>	4.3	4.8
	The Hongkong and Shanghai Banking Corporation	<b>10.1</b>	10.7	12.7
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	<b>6.9</b>	6.0	6.5
	HSBC Bank Malaysia	<b>0.7</b>	0.6	0.6
	HSBC Bank Middle East	<b>1.4</b>	1.3	1.1
North America	HSBC Bank USA	<b>10.1</b>	11.3	10.7
	HSBC Finance	<b>8.3</b>	10.0	9.3



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	HSBC Bank Canada	<b>3.3</b>	2.4	2.6
Latin America	HSBC Mexico	<b>2.5</b>	1.7	1.6
	Brazilian operations <sup>1</sup>	<b>1.6</b>	1.5	1.4
	HSBC Bank Panama	<b>0.7</b>	0.2	0.1
	HSBC Bank Argentina	<b>0.2</b>	0.1	0.1
	Other operations (including consolidation adjustments)	<b>0.7</b>	6.5	5.6
		<b>100.0</b>	100.0	100.0

*For footnotes, see page 170.*

[Back to Contents](#)**Analysis of changes in net interest income**

The following table allocates changes in net interest income between volume and rate for 2007 compared with 2006, and for 2006 compared with 2005.

## Interest income

		<b>Increase/(decrease) in 2007 compared with 2006</b>			<b>Increase/(decrease) in 2006 compared with 2005</b>			
		<b>2007 US\$m</b>	<b>Volume US\$m</b>	<b>Rate US\$m</b>	<b>2006 US\$m</b>	<b>Volume US\$m</b>	<b>Rate US\$m</b>	<b>2005 US\$m</b>
<b>Short-term funds and loans and advances to banks</b>								
Europe	HSBC Bank	<b>2,592</b>	<b>729</b>	<b>327</b>	1,536	424	338	774
	HSBC Private Banking Holdings (Suisse)	<b>229</b>	<b>13</b>	<b>26</b>	190	42	35	113
	HSBC France	<b>1,294</b>	<b>390</b>	<b>214</b>	690	77	226	387
Hong Kong	Hang Seng Bank	<b>609</b>	<b>126</b>	<b>□</b>	483	82	113	288
	The Hongkong and Shanghai Banking Corporation	<b>2,352</b>	<b>484</b>	<b>223</b>	1,645	54	533	1,058
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	<b>810</b>	<b>229</b>	<b>61</b>	520	52	117	351
	HSBC Bank Malaysia	<b>103</b>	<b>13</b>	<b>3</b>	87	20	18	49
	HSBC Bank Middle East	<b>324</b>	<b>100</b>	<b>16</b>	208	35	62	111
North America	HSBC Bank USA	<b>477</b>	<b>54</b>	<b>(42)</b>	465	204	110	151
	HSBC Bank Canada	<b>174</b>	<b>28</b>	<b>8</b>	138	31	45	62
Latin America	HSBC Mexico	<b>239</b>	<b>11</b>	<b>1</b>	227	31	(32)	228
	Brazilian operations <sup>3</sup>	<b>645</b>	<b>230</b>	<b>(157)</b>	572	141	(134)	565
	HSBC Bank Panama	<b>33</b>	<b>24</b>	<b>□</b>	9	3	3	3
	HSBC Bank Argentina	<b>16</b>	<b>4</b>	<b>4</b>	8	(2)	3	7
Other operations		<b>898</b>	<b>89</b>	<b>191</b>	618	52	113	453
		<b>10,795</b>	<b>2,561</b>	<b>838</b>	7,396	1,162	1,634	4,600
<b>Loans and advances to customers</b>								
Europe	HSBC Bank	<b>18,078</b>	<b>669</b>	<b>3,243</b>	14,166	1,378	565	12,223
	HSBC Private Banking Holdings (Suisse)	<b>507</b>	<b>127</b>	<b>42</b>	338	49	78	211
	HSBC France	<b>3,219</b>	<b>699</b>	<b>57</b>	2,463	448	305	1,710
	HSBC Finance	<b>611</b>	<b>(50)</b>	<b>(10)</b>	671	(438)	23	1,086
Hong Kong	Hang Seng Bank	<b>2,120</b>	<b>193</b>	<b>(25)</b>	1,952	61	568	1,323
	The Hongkong and Shanghai Banking Corporation	<b>2,901</b>	<b>51</b>	<b>7</b>	2,843	156	626	2,061

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Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	<b>4,321</b>	<b>471</b>	<b>401</b>	3,449	314	476	2,659
	HSBC Bank Malaysia	<b>507</b>	<b>80</b>	<b>(3)</b>	430	55	50	325
	HSBC Bank Middle East	<b>1,200</b>	<b>178</b>	<b>65</b>	957	172	150	635
North America	HSBC Bank USA	<b>6,585</b>	<b>106</b>	<b>338</b>	6,141	114	433	5,594
	HSBC Finance	<b>18,086</b>	<b>732</b>	<b>293</b>	17,061	3,279	475	13,307
	HSBC Bank Canada	<b>2,598</b>	<b>495</b>	<b>66</b>	2,037	331	267	1,439
Latin America	HSBC Mexico	<b>2,187</b>	<b>380</b>	<b>275</b>	1,532	389	(67)	1,210
	Brazilian operations <sup>3</sup>	<b>3,895</b>	<b>1,409</b>	<b>(758)</b>	3,244	716	(119)	2,647
	HSBC Bank Panama	<b>778</b>	<b>686</b>	□	92	13	12	67
	HSBC Bank Argentina	<b>241</b>	<b>106</b>	<b>28</b>	107	(10)	(5)	122
Other operations		<b>1,790</b>	<b>118</b>	<b>144</b>	1,528	(314)	557	1,285
		<b>69,624</b>	<b>5,891</b>	<b>4,722</b>	59,011	5,756	5,351	47,904

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HSBC HOLDINGS PLC

**Report of the Directors: Financial Review**

(continued)

*Other financial information > Analysis of changes in net interest income*

Interest income (continued)

		<b>Increase/(decrease) in 2007 compared with 2006</b>			Increase/(decrease) in 2006 compared with 2005			
		<b>2007 US\$m</b>	<b>Volume US\$m</b>	<b>Rate US\$m</b>	2006 US\$m	Volume US\$m	Rate US\$m	2005 US\$m
<b>Financial investments</b>								
Europe	HSBC Bank	<b>2,431</b>	<b>146</b>	<b>308</b>	1,977	251	429	1,297
	HSBC Private Banking Holdings (Suisse)	<b>511</b>	<b>74</b>	<b>46</b>	391	□	49	342
	HSBC France	<b>511</b>	<b>291</b>	<b>125</b>	95	(62)	14	143
Hong Kong	Hang Seng Bank	<b>1,550</b>	<b>157</b>	<b>169</b>	1,224	134	275	815
	The Hongkong and Shanghai Banking Corporation	<b>1,017</b>	<b>16</b>	<b>90</b>	911	(286)	273	924
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	<b>1,065</b>	<b>281</b>	<b>47</b>	737	81	64	592
	HSBC Bank Malaysia	<b>56</b>	<b>21</b>	<b>(1)</b>	36	(8)	3	41
	HSBC Bank Middle East	<b>174</b>	<b>118</b>	<b>(16)</b>	72	3	25	44
North America	HSBC Bank USA	<b>1,189</b>	<b>58</b>	<b>22</b>	1,109	133	112	864
	HSBC Finance	<b>229</b>	<b>19</b>	<b>10</b>	200	(12)	(9)	221
	HSBC Bank Canada	<b>258</b>	<b>69</b>	<b>15</b>	174	12	46	116
Latin America	HSBC Mexico	<b>319</b>	<b>(76)</b>	<b>(32)</b>	427	(110)	(46)	583
	Brazilian operations <sup>3</sup>	<b>672</b>	<b>225</b>	<b>(54)</b>	501	214	(37)	324
	HSBC Bank Panama	<b>58</b>	<b>37</b>	<b>□</b>	21	18	(2)	5
	HSBC Bank Argentina	<b>68</b>	<b>31</b>	<b>(1)</b>	38	10	5	23
Other operations		<b>1,407</b>	<b>121</b>	<b>95</b>	1,191	350	(35)	876
		<b>11,515</b>	<b>1,634</b>	<b>777</b>	9,104	538	1,356	7,210

Interest expense

**Deposits by banks**

Europe	HSBC Bank	<b>2,148</b>	<b>477</b>	<b>360</b>	1,311	5	269	1,037
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	HSBC Private Banking Holdings (Suisse)	22	(11)	□	33	3	10	20
	HSBC France	1,358	292	180	886	170	134	582
Hong Kong	Hang Seng Bank	123	40	(1)	84	5	18	61
	The Hongkong and Shanghai Banking Corporation	150	40	(15)	125	(23)	32	116
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	445	156	43	246	44	34	168
	HSBC Bank Malaysia	12	3	□	9	1	3	5
	HSBC Bank Middle East	32	11	(2)	23	(13)	9	27
North America	HSBC Bank USA	414	182	24	208	(26)	32	202
	HSBC Bank Canada	93	7	18	68	22	12	34
Latin America	HSBC Mexico	63	13	□	50	(18)	(2)	70
	Brazilian operations <sup>3</sup>	106	50	(45)	101	(30)	6	125
	HSBC Bank Panama	66	49	□	17	4	6	7
	HSBC Bank Argentina	9	3	1	5	(3)	□	8
Other operations		291	(51)	8	334	85	45	204
		<u>5,332</u>	<u>1,267</u>	<u>565</u>	<u>3,500</u>	251	583	<u>2,666</u>

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## Interest expense (continued)

		<b>Increase/(decrease) in 2007 compared with 2006</b>			Increase/(decrease) in 2006 compared with 2005			
		<b>2007 US\$m</b>	<b>Volume US\$m</b>	<b>Rate US\$m</b>	2006 US\$m	Volume US\$m	Rate US\$m	2005 US\$m
<b>Customer accounts</b>								
Europe	HSBC Bank	<b>10,576</b>	<b>1,577</b>	<b>1,968</b>	7,031	987	685	5,359
	HSBC Private Banking Holdings (Suisse)	<b>1,485</b>	<b>237</b>	<b>179</b>	1,069	170	277	622
	HSBC France	<b>1,226</b>	<b>264</b>	<b>210</b>	752	(24)	165	611
Hong Kong	Hang Seng Bank	<b>1,900</b>	<b>219</b>	<b>(31)</b>	1,712	48	790	874
	The Hongkong and Shanghai Banking Corporation	<b>3,499</b>	<b>591</b>	<b>(26)</b>	2,934	123	1,489	1,322
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	<b>2,645</b>	<b>646</b>	<b>96</b>	1,903	205	405	1,293
	HSBC Bank Malaysia	<b>260</b>	<b>46</b>	<b>2</b>	212	29	26	157
	HSBC Bank Middle East	<b>578</b>	<b>139</b>	<b>28</b>	411	72	132	207
North America	HSBC Bank USA	<b>3,051</b>	<b>249</b>	<b>312</b>	2,490	233	872	1,385
	HSBC Bank Canada	<b>1,090</b>	<b>152</b>	<b>134</b>	804	80	249	475
Latin America	HSBC Mexico	<b>548</b>	<b>21</b>	<b>56</b>	471	122	161	188
	Brazilian operations <sup>3</sup>	<b>2,163</b>	<b>648</b>	<b>(541)</b>	2,056	706	(509)	1,859
	HSBC Bank Panama	<b>314</b>	<b>280</b>	<b>□</b>	34	6	11	17
	HSBC Bank Argentina	<b>85</b>	<b>38</b>	<b>6</b>	41	2	11	28
Other operations		<b>2,297</b>	<b>200</b>	<b>286</b>	1,811	164	391	1,256
		<b>31,717</b>	<b>5,098</b>	<b>2,888</b>	23,731	2,446	5,632	15,653
<b>Financial liabilities designated at fair value □ own debt issued</b>		<b>3,568</b>	<b>196</b>	<b>212</b>	3,160	227	896	2,037
<b>Debt securities in issue</b>								
Europe	HSBC Bank	<b>3,753</b>	<b>816</b>	<b>890</b>	2,047	1,095	(865)	1,817
	HSBC France	<b>1,207</b>	<b>285</b>	<b>289</b>	633	122	197	314
	HSBC Finance	<b>18</b>	<b>(18)</b>	<b>4</b>	32	(64)	19	77
Hong Kong	Hang Seng Bank	<b>80</b>	<b>4</b>	<b>12</b>	64	3	8	53
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	<b>559</b>	<b>54</b>	<b>67</b>	438	71	52	315
	HSBC Bank Malaysia	<b>13</b>	<b>(2)</b>	<b>2</b>	13	(6)	3	16
	HSBC Bank Middle East	<b>119</b>	<b>119</b>	<b>□</b>	□	□	□	□

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North America	HSBC Bank USA	<b>1,232</b>	<b>(152)</b>	<b>(23)</b>	1,407	138	196	1,073
	HSBC Finance	<b>5,311</b>	<b>142</b>	<b>122</b>	5,047	1,633	15	3,399
	HSBC Bank Canada	<b>640</b>	<b>180</b>	□	460	89	103	268
Latin America	HSBC Mexico	<b>110</b>	<b>83</b>	<b>4</b>	23	(270)	8	285
	Brazilian operations <sup>3</sup>	<b>115</b>	<b>72</b>	<b>(27)</b>	70	50	(47)	67
	HSBC Bank Panama	<b>45</b>	<b>43</b>	□	2	□	2	□
	HSBC Bank Argentina	□	□	□	□	(1)	□	1
Other operations	<b>(13)</b>	<b>119</b>	<b>(240)</b>	108	(50)	68	90	
		<b>13,189</b>	<b>1,777</b>	<b>1,068</b>	10,344	2,475	94	7,775

Footnotes to □Average balance sheet and net interest income□ and □Analysis of changes in net interest income□.

- 1 *Interest income on trading assets is reported as □Net trading income□ in the consolidated income statement.*
- 2 *Interest income on financial assets designated at fair value is reported as □Net income from financial instruments designated at fair value□ in the consolidated income statement.*
- 3 *Brazilian operations comprise HSBC Bank Brasil S.A.-Banco Múltiplo and subsidiaries, plus HSBC Serviços e Participações Limitad a.*
- 4 *This table analyses interest-bearing bank deposits only. See page 180 for an analysis of all bank deposits.*
- 5 *This table analyses interest-bearing customer accounts only. See page 181 for an analysis of all customer accounts.*
- 6 *Interest expense on financial liabilities designated at fair value is reported as □Net income on financial liabilities designated at fair value□ in the consolidated income statement other than interest on own debt.*

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HSBC HOLDINGS PLC

## Report of the Directors: Financial Review

(continued)

*Other financial information > Share capital and reserves*

### Share capital and reserves

#### Authorised share capital

The authorised share capital of HSBC Holdings at 31 December 2007 was US\$7,500,100,000 divided into 15,000 million ordinary shares of US\$0.50 each and 10 million non-cumulative preference shares of US\$0.01 each; £401,500 divided into 10 million non-cumulative preference shares of £0.01 each and 301,500 non-voting deferred shares of £1 each; and 100,000 divided into 10 million non-cumulative preference shares of 0.01 each.

The percentage of the total authorised share capital of HSBC Holdings at 31 December 2007 represented by the numbers of ordinary shares of US\$0.50 each, non-cumulative preference shares of £0.01 each, non-cumulative preference shares of US\$0.01 each, non-cumulative preference shares of 0.01 each and non-voting deferred shares of £1 each was approximately 99.9860, 0.0027, 0.0013, 0.0020 and 0.0081 per cent respectively.

#### Issued share capital

The issued share capital of HSBC Holdings at 31 December 2007 was US\$5,915 million divided into 11,829,052,317 ordinary shares of US\$0.50 each; 1,450,000 non-cumulative preference shares of US\$0.01 each; and 301,500 non-voting deferred shares of £1 each.

#### Rights and obligations attaching to shares

The rights and obligations attaching to each class of share in the authorised share capital of HSBC Holdings are set out in the Articles of Association of HSBC Holdings. Set out below is a summary of the rights and obligations attaching to each class of shares with respect to voting, dividends, capital and, in the case of the preference shares, redemption.

##### *Ordinary shares*

Subject to the Companies Act 2006 and the Articles of Association of HSBC Holdings, in a general meeting of HSBC Holdings, every holder of ordinary shares who is present in person or by proxy shall on a show of hands have one vote and every holder of ordinary shares present in person or by proxy shall on a poll have one vote for every share he or she holds. Where any shareholder is, under the rules governing the listing of securities on any stock exchange on which all or any shares of HSBC Holdings are for the time being listed or traded, required to abstain from voting on any particular resolution or restricted to voting only for or only against any particular resolution, any votes cast by or

on behalf of such holder in contravention of such requirement or restriction will not be counted.

Subject to the Companies Act 2006 and the Articles of Association of HSBC Holdings, HSBC Holdings may, by ordinary resolution, declare dividends to be paid to the holders of ordinary shares, however, no dividend shall exceed the amount recommended by the Board. The Board may pay interim dividends as appears to the Board to be justified by the profits of HSBC Holdings available for distribution. All dividends shall be apportioned and paid proportionately to the percentage of the nominal amount paid up on the shares during any portion or portions of the period in respect of which the dividend is paid, but if any share is issued on terms providing that it shall rank



for dividend as from a particular date, it shall rank for dividend accordingly. Subject to the Articles of Association of HSBC Holdings, the Board may, with the prior authority of an ordinary resolution of HSBC

Holdings and subject to such terms and conditions as the Board may determine, offer to any holders of ordinary shares the right to elect to receive ordinary shares of the same or a different currency, credited as fully paid, instead of cash in any currency in respect of the whole (or some part, to be determined by the Board) of any dividend specified by the ordinary resolution. At the 2007 Annual General Meeting shareholders gave authority to the Directors to offer a scrip dividend alternative until the conclusion of the Annual General Meeting in 2012.

Subject to the relevant insolvency laws and the Articles of Association of HSBC Holdings, if HSBC Holdings is wound up, the assets available for distribution among the holders of ordinary shares will be distributed among such holders in proportion to the number of ordinary shares held by them respectively, such distribution to be adjusted to take account of any amount remaining unpaid on a holder's share. On a winding up, the liquidator may, with the sanction of a special resolution of HSBC Holdings and any other sanction required by law, divide among the shareholders in specie the whole or any part of the assets of HSBC Holdings and may, for that purpose, value any assets and determine how the division shall be carried out as between the shareholders or different classes of shareholders.

*Preference shares*

The non-cumulative preference shares of £0.01 each, the non-cumulative preference shares of US\$0.01 each (the Dollar Preference Shares) and the non-cumulative preference shares of 0.01 each carry the same rights and obligations under the Articles of Association save in respect of the timing of and

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payment of proceeds from the redemption of each class of share, to the extent issued, and certain rights and obligations that attach to each class of preference share as determined by the Board prior to allotment of the relevant preference shares. The Dollar Preference Shares are the only class of the preference shares which have been issued and allotted to date.

Holders of the preference shares will only be entitled to attend and vote at general meetings of HSBC Holdings if any dividend payable on the relevant preference shares in respect of such period as the Board shall determine prior to allotment thereof (which, in the case of the Dollar Preference Shares in issue at 3 March 2008, is four consecutive dividend payment dates) is not paid in full or in such other circumstances, and upon and subject to such terms, as the Board may determine prior to allotment of the relevant preference shares. Whenever holders of the relevant preference shares are entitled to vote on a resolution at a general meeting, on a show of hands every such holder who is present in person or by proxy shall have one vote and on a poll every such holder who is present in person or by proxy shall have one vote per preference share held by him or her or such number of votes per share as the Board shall determine prior to allotment of such share.

Subject to the Articles of Association, holders of the relevant preference shares shall have the right to a non-cumulative preferential dividend at such rate, on such dates and on such other terms and conditions as may be determined by the Board prior to allotment thereof in priority to the payment of any dividend to the holders of ordinary shares and any other class of shares of HSBC Holdings in issue (other than (i) the other preference shares in issue and any other shares expressed to rank *pari passu* therewith as regards income; and (ii) any shares which by their terms rank in priority to the relevant preference shares as regards income). Dividends on the Dollar Preference Shares in issue at 3 March 2008 are paid quarterly at the sole and absolute discretion of the Board of Directors. The Board of Directors will not declare a dividend on the Dollar Preference Shares if payment of the dividend would cause HSBC Holdings not to meet the applicable capital adequacy requirements of the FSA or the profit of HSBC Holdings available for distribution as dividends is not sufficient to enable HSBC Holdings to pay in full both dividends on the relevant preference shares and dividends on any other shares that are scheduled to be paid on the same date and that have an equal right to dividends. HSBC Holdings may not declare or pay dividends on any

class of its shares ranking lower in the right to dividends than the preference shares nor redeem nor purchase in any manner any of its other shares ranking equal with or lower than the preference shares unless it has paid in full, or set aside an amount to provide for payment in full, the dividends on the preference shares for the then-current dividend period.

The preference shares carry no rights to participate in the profits or assets of HSBC Holdings other than as set out in the Articles of Association, subject to the Companies Act 1985, do not confer any right to participate in any offer or invitation by way of rights or otherwise to subscribe for additional shares in HSBC Holdings, do not confer any right of conversion and do not confer any right to participate in any issue or bonus shares or shares issued by way of capitalisation of reserves.

Subject to the relevant insolvency laws and the Articles of Association of HSBC Holdings, holders of the relevant preference shares have the right in a winding up of HSBC Holdings to receive out of the assets of HSBC Holdings available for distribution to its shareholders, in priority to any payment to the holders of the ordinary shares and any other class of shares of HSBC Holdings in issue (other than (i) the other relevant preference shares and any other shares expressed to rank *pari passu* therewith as regards repayment of capital; and (ii) any shares which by their terms rank in priority to the relevant preference shares as regards repayment of capital), a sum equal to any unpaid dividend on the relevant preference shares which is payable as a dividend in accordance with or pursuant to the Articles of Association and the amount paid up or credited as paid up on the relevant preference shares together with such premium (if any) as may be determined by the Board prior to allotment thereof.

HSBC Holdings may redeem the relevant preference shares in accordance with the Articles of Association and the terms on which the relevant preference shares were issued and allotted. In the case of the Dollar Preference Shares in issue at 3 March 2008, HSBC Holdings may redeem such shares in whole at any time on or after 16 December 2010, with the consent of the FSA.

*Non-voting deferred shares*

The non-voting deferred shares are held by a subsidiary undertaking of HSBC Holdings. Holders of the non-voting deferred shares are not entitled to receive dividends on these shares. In addition, on winding up or other return of capital, holders are entitled to receive the amount paid up on their shares

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HSBC HOLDINGS PLC

**Report of the Directors: Financial Review**

(continued)

*Other financial information > Share capital and reserves /  
Short-term borrowings*

after distribution to ordinary shareholders of £10,000,000 in respect of each ordinary share held by them. The holders of the non-voting deferred shares are not entitled to receive notice of or to attend (either personally or by proxy) any general meeting of HSBC Holdings or to vote (either personally or by proxy) on any resolution to be proposed thereat.

To be registered, a transfer of shares must be in relation to a share which is fully paid up and on which the Company has no lien and to one class of shares denominated in the same currency. The transfer must be in favour of a single transferee or no more than four joint transferees and it must be duly stamped (if required). The transfer must be delivered to the registered office of the Company or to its Registrars accompanied by the certificate to which it relates or such other evidence that proves the title of the transferor.

If a shareholder or any person appearing to be interested in the Company's shares has been sent a notice under section 793 of the Companies Act 2006 (which confers upon public companies the power to require information from any person whom the Company knows or has reasonable cause to believe to be interested in the shares) and has failed in relation to any shares (the "default shares") to supply the information requested within the period set out in the notice, then the member is not entitled to be present at or to vote the default shares at any general meeting or to exercise any other right conferred by being a shareholder. If the default shares represent at least 0.25 per cent in nominal value of the issued shares of that class any dividend shall be withheld by the Company, without interest and no election for the scrip dividend alternative may be made. No transfer of any shares held by the member will be registered, except in limited circumstances.

The percentage of the total issued share capital of HSBC Holdings at 31 December 2007 represented by the ordinary shares of US\$0.50 each, non-cumulative preference shares of US\$0.01 each and non-voting deferred shares of £1 each was approximately 99.9895, 0.0002, and 0.0102 per cent respectively.

The following events occurred during the year in relation to the share capital of HSBC Holdings:

**Scrip dividends**

1. 11,899,858 ordinary shares were issued at par in January 2007 to shareholders who elected to receive new shares in lieu of the third interim dividend for 2006. The market value per share used to calculate shareholders' entitlements to new shares was US\$18.7596, being the US dollar equivalent of £9.65.
2. 121,070,708 ordinary shares were issued at par in May 2007 to shareholders who elected to receive new shares in lieu of the fourth interim dividend for 2006. The market value per share used to calculate shareholders' entitlements to new shares was US\$17.4801, being the US dollar equivalent of £8.898.
3. 38,617,708 ordinary shares were issued at par in July 2007 to shareholders who elected to receive new shares in lieu of the first interim dividend for 2007. The market value per share used to calculate shareholders' entitlements to new shares was US\$18.4375, being the US dollar equivalent of £9.352.
4. 51,950,381 ordinary shares were issued at par in October 2007 to shareholders who elected to receive new shares in lieu of the second interim dividend for 2007. The market value per share used to calculate shareholders' entitlements to new shares was US\$17.5483, being the US dollar equivalent of £8.874.

**All-Employee share plans**

5. In connection with the exercise of options under the HSBC Holdings savings-related share option plans: 16,135,919 ordinary shares were issued at prices ranging from £5.3496 to £7.6736; 1,180,575 ordinary shares were issued at prices ranging from HK\$103.4401 to HK\$108.4483; 595,868 ordinary shares were issued at prices ranging from US\$13.329 to US\$14.1621; and 38,928 ordinary shares were issued at £11.0062. Options over 10,251,717 ordinary shares lapsed.
6. 2,682,894 ordinary shares were issued at £10.9675 per share and 257,193 ordinary shares were issued at £12.3385 per share in connection with a Plan d'Épargne Entreprise for the benefit of non-UK resident employees of HSBC France and its subsidiaries.
7. Options over 30,105,239 ordinary shares were granted at nil consideration on 25 April 2007 to nearly 72,000 HSBC employees resident in nearly 70 countries and territories under the HSBC Holdings savings-related share option plans.

**Discretionary share incentive plans**

8. 3,377,896 ordinary shares were issued at prices ranging from £5.016 to £7.46 per share in connection with the exercise of options under the HSBC Holdings Executive Share Option

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Scheme. Options over 420,667 ordinary shares lapsed.

9. 8,351,649 ordinary shares were issued at prices ranging from £6.91 to £8.712 per share in connection with the exercise of options under the HSBC Holdings Group Share Option Plan. Options over 8,221,968 ordinary shares lapsed.

**HSBC Finance**

10. 685,005 ordinary shares were issued at prices ranging from US\$16.66 to US\$19.19 per share in connection with the vesting of Restricted Stock Rights under HSBC Finance share plans that have been converted into rights over HSBC Holdings ordinary shares.

**Authority to repurchase ordinary shares**

11. At the Annual General Meeting in 2007, shareholders renewed the authority for the Company to make market repurchases of ordinary shares. The authority is to make market repurchases of up to 1,158,660,000 ordinary shares. The Directors have not exercised this authority. In accordance with the terms of a waiver granted by the Hong Kong Stock Exchange on 19 December 2005, HSBC Holdings will comply with the applicable law and regulation in the UK in relation to the holding of any shares in treasury and with the conditions of the waiver, in connection with any shares it may hold in treasury.

**Authority to allot shares**

12. At the Annual General Meeting in 2007 shareholders renewed the general authority for the Directors to allot new shares. The general authority is to allot up to 2,317,320,000 ordinary shares, 10,000,000 non-cumulative preference shares of £0.01 each, 8,550,000 non-cumulative preference shares of US\$0.01 each and 10,000,000 non-cumulative preference shares of ¥0.01 each. Within this, the Directors have authority to allot up to a maximum of 579,330,000 ordinary shares wholly for cash to persons other than existing shareholders.

Other than as described in paragraphs 1 to 6 and 8 to 10 above, the Directors did not allot any shares during 2007.

**Short-term borrowings**

HSBC includes short-term borrowings within customer accounts, deposits by banks and debt securities in issue and does not show short-term borrowings separately on the balance sheet. Short-term borrowings are defined by the US Securities and Exchange Commission (SEC) as Federal funds purchased and securities sold under agreements to repurchase, commercial paper and other short-term borrowings. HSBC's only significant short-term borrowings are securities sold under agreements to repurchase and certain debt securities in issue. Additional information on these is provided in the tables below.

	Year ended 31 December		
	2007 US\$m	2006 US\$m	2005 US\$m
<b>Securities sold under agreements to repurchase</b>			
Outstanding at 31 December	140,001	97,139	75,745
Average amount outstanding during the year	129,779	102,715	74,143
Maximum quarter-end balance outstanding during the year	148,601	109,689	78,590
Weighted average interest rate during the year	5.4%	4.3%	3.6%
Weighted average interest rate at the year-end	4.8%	4.6%	4.0%
<b>Short-term bonds</b>			
Outstanding at 31 December	51,792	37,906	40,642
Average amount outstanding during the year	39,153	37,729	31,908

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Maximum quarter-end balance outstanding during the year	<b>51,792</b>	38,907	40,642
Weighted average interest rate during the year	<b>7.0%</b>	5.1%	4.6%
Weighted average interest rate at the year-end	<b>6.5%</b>	4.8%	3.7%

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HSBC HOLDINGS PLC

**Report of the Directors: Financial Review**

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*Other financial information > Contractual obligations / Ratios / Loan maturities*

**Contractual obligations**

The table below provides details of HSBC's material contractual obligations as at 31 December 2007.

	<b>Payments due by period</b>			
	<b>Total US\$m</b>	<b>Less than 1 year US\$m</b>	<b>1-5 years US\$m</b>	<b>More than 5 years US\$m</b>
Long-term debt obligations	318,653	111,101	131,345	76,207
Term deposits and certificates of deposit	278,693	263,557	15,136	□
Capital (finance) lease obligations	703	15	27	661
Operating lease obligations	4,559	799	2,024	1,736
Purchase obligations	942	420	522	□
Short positions in debt securities and equity shares	108,246	83,598	9,690	14,958
Current tax liability	2,559	2,559	□	□
Pension obligations	9,055	625	3,450	4,980
	<b>723,410</b>	<b>462,674</b>	<b>162,194</b>	<b>98,542</b>

**Ratios of earnings to combined fixed charges (and preference share dividends)**

	Year ended 31 December				
	2007	2006	2005	2004	2003
<b>Ratios of earnings to combined fixed charges</b>					
Ratios in accordance with IFRSs					
□ excluding interest on deposits	7.52	7.93	9.60	8.64	□
□ including interest on deposits	1.34	1.41	1.59	1.86	□
Ratios in accordance with UK GAAP					
□ excluding interest on deposits	□	□	□	8.07	7.41
□ including interest on deposits	□	□	□	1.81	1.80
<b>Ratios of earnings to combined fixed charges and preference share dividends</b>					
Ratios in accordance with IFRSs:					
□ excluding interest on deposits	6.96	7.22	9.16	8.64	□
□ including interest on deposits	1.34	1.40	1.59	1.86	□



Ratios in accordance with UK GAAP

□ excluding interest on deposits	□	□	□	8.07	7.41
□ including interest on deposits	□	□	□	1.81	1.80

*For the purpose of calculating the ratios, earnings consist of income from continuing operations before taxation and minority interests, plus fixed charges, and after deduction of the unremitted pre-tax income of associated undertakings. Fixed charges consist of total interest expense, including or excluding interest on deposits, as appropriate, preference share dividends, as applicable, and the proportion of rental expense deemed representative of the interest factor.*

*The above table contains ratios based on UK GAAP, HSBC's previous primary GAAP, which is not comparable to financial information based upon IFRSs, as explained in HSBC's 2004 IFRSs Comparative Financial Information published on 5 July 2004.*

[Back to Contents](#)**Loan maturity and interest sensitivity analysis**

At 31 December 2007, the geographical analysis of loan maturity and interest sensitivity by loan type on a contractual repayment basis was as follows:

	Europe US\$m	Hong Kong US\$m	Rest of Asia- Pacific US\$m	North America US\$m	Latin America US\$m	Total US\$m
<b>Maturity of 1 year or less</b>						
Loans and advances to banks	93,786	63,474	39,534	15,906	9,981	222,681
Commercial loans to customers						
Commercial, industrial and international trade	84,293	14,259	29,713	5,293	9,589	143,147
Real estate and other property related	21,048	6,434	5,554	10,541	1,442	45,019
Non-bank financial institutions	57,054	1,395	4,004	20,342	2,068	84,863
Governments	1,423	68	1,080	91	465	3,127
Other commercial	33,379	2,097	6,176	8,723	2,977	53,352
	197,197	24,253	46,527	44,990	16,541	329,508
Hong Kong Government Home Ownership Scheme Residential mortgages and other personal loans	□	438	□	□	□	438
	37,382	14,499	14,632	50,872	10,556	127,941
Loans and advances to customers	234,579	39,190	61,159	95,862	27,097	457,887
	328,365	102,664	100,693	111,768	37,078	680,568
<b>Maturity after 1 year but within 5 years</b>						
Loans and advances to banks	10,397	263	236	634	80	11,610
Commercial loans to customers						
Commercial, industrial and international trade	22,765	3,045	5,650	6,370	3,376	41,206
Real estate and other property related	14,809	9,832	5,738	7,412	962	38,753
Non-bank financial institutions	3,035	456	1,160	1,690	858	7,199
Governments	342	263	415	95	242	1,357
Other commercial	11,637	2,191	2,969	2,242	1,376	20,415
	52,588	15,787	15,932	17,809	6,814	108,930
Hong Kong Government Home Ownership Scheme Residential mortgages and other personal loans.	□	1,384	□	□	□	1,384
	42,576	9,007	9,506	64,799	6,644	132,532
Loans and advances to customers	95,164	26,178	25,438	82,608	13,458	242,846

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	<b>105,561</b>	<b>26,441</b>	<b>25,674</b>	<b>83,242</b>	<b>13,538</b>	<b>254,456</b>
Interest rate sensitivity of loans and advances to banks and commercial loans to customers:						
Fixed interest rate	<b>13,470</b>	<b>209</b>	<b>2,662</b>	<b>3,539</b>	<b>1,967</b>	<b>21,847</b>
Variable interest rate	<b>49,515</b>	<b>15,841</b>	<b>13,506</b>	<b>14,904</b>	<b>4,927</b>	<b>98,693</b>
	<b>62,985</b>	<b>16,050</b>	<b>16,168</b>	<b>18,443</b>	<b>6,894</b>	<b>120,540</b>
<b>Maturity after 5 years</b>						
Loans and advances to banks	<b>351</b>	<b>□</b>	<b>91</b>	<b>26</b>	<b>2,614</b>	<b>3,082</b>
Commercial loans to customers						
Commercial, industrial and international trade	<b>13,301</b>	<b>436</b>	<b>1,098</b>	<b>2,274</b>	<b>576</b>	<b>17,685</b>
Real estate and other property related	<b>12,090</b>	<b>4,203</b>	<b>964</b>	<b>4,608</b>	<b>615</b>	<b>22,480</b>
Non-bank financial institutions	<b>1,127</b>	<b>632</b>	<b>27</b>	<b>220</b>	<b>2,713</b>	<b>4,719</b>
Governments	<b>534</b>	<b>1</b>	<b>172</b>	<b>62</b>	<b>455</b>	<b>1,224</b>
Other commercial	<b>10,820</b>	<b>1,669</b>	<b>1,148</b>	<b>1,315</b>	<b>421</b>	<b>15,373</b>
	<b>37,872</b>	<b>6,941</b>	<b>3,409</b>	<b>8,479</b>	<b>4,780</b>	<b>61,481</b>
Hong Kong Government Home Ownership Scheme Residential mortgages and other personal loans .	<b>□</b>	<b>2,120</b>	<b>□</b>	<b>□</b>	<b>□</b>	<b>2,120</b>
	<b>88,591</b>	<b>19,527</b>	<b>12,772</b>	<b>114,891</b>	<b>4,580</b>	<b>240,361</b>
Loans and advances to customers	<b>126,463</b>	<b>28,588</b>	<b>16,181</b>	<b>123,370</b>	<b>9,360</b>	<b>303,962</b>
	<b>126,814</b>	<b>28,588</b>	<b>16,272</b>	<b>123,396</b>	<b>11,974</b>	<b>307,044</b>
Interest rate sensitivity of loans and advances to banks and commercial loans to customers						
Fixed interest rate	<b>10,055</b>	<b>1</b>	<b>992</b>	<b>912</b>	<b>509</b>	<b>12,469</b>
Variable interest rate	<b>28,168</b>	<b>6,940</b>	<b>2,508</b>	<b>7,593</b>	<b>6,885</b>	<b>52,094</b>
	<b>38,223</b>	<b>6,941</b>	<b>3,500</b>	<b>8,505</b>	<b>7,394</b>	<b>64,563</b>

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HSBC HOLDINGS PLC

**Report of the Directors: Financial Review**

(continued)

*Other financial information > Deposits***Deposits**

The following tables analyse the average amount of bank deposits, customer deposits and certificates of deposit (CDs) and other money market instruments (which are included within Debt securities in issue in the balance sheet), together with the average

interest rates paid thereon for each of the past three years. The geographical analysis of average deposits is based on the location of the office in which the deposits are recorded and excludes balances with HSBC companies. The Other category includes securities sold under agreements to repurchase.

Year ended 31 December

	2007		2006		2005	
	Average balance US\$m	Average rate %	Average balance US\$m	Average rate %	Average balance US\$m	Average rate %
<b>Deposits by banks</b>						
Europe						
Demand and other non-interest bearing	6,359		9,814		14,252	
Demand interest bearing	11,036	3.8	8,368	3.7	9,418	2.9
Time	38,470	4.7	27,447	4.0	28,021	3.0
Other	28,770	4.8	23,396	3.5	16,111	3.6
	<b>84,635</b>		<b>69,025</b>		<b>67,802</b>	
Hong Kong						
Demand and other non-interest bearing	1,331		1,031		2,054	
Demand interest bearing	2,420	4.3	2,428	4.6	3,104	3.5
Time	3,267	4.5	2,016	4.3	2,012	3.2
Other	251	0.4	362	3.3	218	2.3
	<b>7,269</b>		<b>5,837</b>		<b>7,388</b>	
Rest of Asia-Pacific						
Demand and other non-interest bearing	1,897		1,618		2,164	
Demand interest bearing	3,167	2.4	1,960	2.4	1,442	1.9
Time	6,433	5.1	3,645	4.8	4,375	4.3
Other	2,768	4.8	2,157	4.5	761	5.4

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	<b>14,265</b>		9,380		8,742	
North America						
Demand and other □ non-interest bearing	<b>827</b>		767		1,334	
Demand □ interest bearing	<b>3,759</b>	<b>4.8</b>	3,033	5.3	3,647	3.6
Time	<b>6,746</b>	<b>6.0</b>	3,543	5.4	2,406	6.0
Other	<b>169</b>	<b>7.1</b>	699	5.6	38	5.3
	<b>11,501</b>		8,042		7,425	
Latin America						
Demand and other □ non-interest bearing	<b>808</b>		702		49	
Demand □ interest bearing	<b>153</b>	<b>5.9</b>	96	6.3	117	7.7
Time	<b>2,690</b>	<b>6.5</b>	1,732	5.5	1,810	6.4
Other	<b>1,010</b>	<b>8.0</b>	683	9.4	1,075	8.9
	<b>4,661</b>		3,213		3,051	
Total						
Demand and other □ non-interest bearing	<b>11,222</b>		13,932		19,853	
Demand □ interest bearing	<b>20,535</b>	<b>3.8</b>	15,885	4.5	17,728	3.1
Time	<b>57,606</b>	<b>4.9</b>	38,383	4.5	38,624	3.5
Other	<b>32,968</b>	<b>5.0</b>	27,297	3.9	18,203	4.1
	<b>122,331</b>		95,497		94,408	

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Year ended 31 December

	2007		2006		2005	
	Average balance US\$m	Average rate %	Average balance US\$m	Average rate %	Average balance US\$m	Average rate %
<b>Customer accounts</b>						
Europe						
Demand and other □ non-interest bearing	34,585	□	33,000	□	28,501	□
Demand □ interest bearing	210,692	3.5	173,150	2.7	146,484	2.4
Savings	62,002	4.6	50,525	3.9	46,248	3.3
Time	69,476	4.9	59,374	4.2	48,201	3.9
Other	14,741	4.5	9,249	4.1	10,967	2.7
	<b>391,496</b>		<b>325,298</b>		<b>280,401</b>	
Hong Kong						
Demand and other □ non-interest bearing	14,214	□	13,011	□	13,365	□
Demand □ interest bearing	107,053	2.2	88,754	2.4	91,723	0.9
Savings	63,649	3.9	58,883	3.8	50,281	2.4
Time	26,712	3.9	20,454	3.6	14,054	2.7
Other	1,164	4.3	51	3.9	15	6.7
	<b>212,792</b>		<b>181,153</b>		<b>169,438</b>	
Rest of Asia-Pacific						
Demand and other □ non-interest bearing	16,438	□	13,107	□	11,825	□
Demand □ interest bearing	41,089	2.4	29,816	2.1	27,721	1.7
Savings	57,950	4.2	42,153	4.3	31,584	3.3
Time	11,538	4.6	10,246	4.5	10,484	3.5
Other	1,835	4.5	2,233	3.5	1,895	3.9
	<b>128,850</b>		<b>97,555</b>		<b>83,509</b>	
North America						
Demand and other □ non-interest bearing	15,175	□	13,662	□	13,627	□
Demand □ interest bearing	15,389	3.3	14,406	2.9	11,723	1.9
Savings	79,529	3.3	65,216	2.8	52,458	1.6
Time	17,655	5.9	21,124	5.4	21,759	3.6
Other	3,234	3.7	3,339	2.0	2,549	4.5
	<b>130,982</b>		<b>117,747</b>		<b>102,116</b>	
Latin America						
Demand and other □ non-interest bearing	10,530	□	7,995	□	5,583	□
Demand □ interest bearing	5,662	2.1	5,438	1.6	6,341	1.2
Savings	24,861	8.8	16,512	11.3	10,980	15.2
Time	12,443	5.9	7,665	5.9	2,529	5.6
Other	1,212	9.5	2,145	13.4	1,429	17.5

	<b>54,708</b>		39,755		26,862	
Total						
Demand and other □ non-interest bearing	<b>90,942</b>	□	80,775	□	72,901	□
Demand □ interest bearing	<b>379,885</b>	<b>3.0</b>	311,564	2.6	283,992	1.8
Savings	<b>287,991</b>	<b>4.4</b>	233,289	4.1	191,551	3.3
Time	<b>137,824</b>	<b>4.9</b>	118,863	4.5	97,027	3.7
Other	<b>22,186</b>	<b>4.7</b>	17,017	4.8	16,855	4.4
	<b>918,828</b>		761,508		662,326	
<b>CDs and other money market instruments</b>						
Europe	<b>66,164</b>	<b>5.0</b>	48,238	4.2	27,778	5.8
Hong Kong	<b>941</b>	<b>3.9</b>	1,191	3.5	1,599	3.1
Rest of Asia-Pacific	<b>7,230</b>	<b>6.0</b>	6,621	5.6	7,467	6.2
North America	<b>23,735</b>	<b>5.4</b>	23,472	4.6	19,566	3.1
Latin America	<b>1,526</b>	<b>6.8</b>	318	10.7	4,657	6.4
	<b>99,596</b>	<b>5.2</b>	79,840	4.5	61,067	5.0

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*Other financial information > CDs and other time deposits /  
Off-balance sheet arrangements and SPEs*

**Certificates of deposit and other time deposits**

At 31 December 2007, the maturity analysis of CDs and other wholesale time deposits, by remaining maturity, was as follows:

	3 months or less US\$m	After 3 months but within 6 months US\$m	After 6 months but within 12 months US\$m	After 12 months US\$m	Total US\$m
<b>Europe</b>					
Certificates of deposit	30,087	2,863	3,066	□	36,016
Time deposits:					
□ banks	35,721	2,089	2,233	4,097	44,140
□ customers	81,134	6,063	2,108	3,554	92,859
	<u>146,942</u>	<u>11,015</u>	<u>7,407</u>	<u>7,651</u>	<u>173,015</u>
<b>Hong Kong</b>					
Certificates of deposit	969	646	974	1,373	3,962
Time deposits:					
□ banks	1,955	□	□	37	1,992
□ customers	22,450	359	233	909	23,951
	<u>25,374</u>	<u>1,005</u>	<u>1,207</u>	<u>2,319</u>	<u>29,905</u>
<b>Rest of Asia-Pacific</b>					
Certificates of deposit	3,816	2,235	1,554	221	7,826
Time deposits:					
□ banks	7,104	863	497	111	8,575
□ customers	10,896	987	673	1,763	14,319
	<u>21,816</u>	<u>4,085</u>	<u>2,724</u>	<u>2,095</u>	<u>30,720</u>
<b>North America</b>					
Certificates of deposit	□	□	□	□	□
Time deposits:					
□ banks	6,164	283	3	3	6,453
□ customers	15,151	327	1,324	1,857	18,659



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	<b>21,315</b>	<b>610</b>	<b>1,327</b>	<b>1,860</b>	<b>25,112</b>
Latin America					
Certificates of deposit	<b>386</b>	<b>1,289</b>	<b>325</b>	<b>610</b>	<b>2,610</b>
Time deposits:					
□ banks	<b>1,289</b>	<b>362</b>	<b>364</b>	<b>355</b>	<b>2,370</b>
□ customers	<b>11,988</b>	<b>1,514</b>	<b>1,213</b>	<b>246</b>	<b>14,961</b>
	<b>13,663</b>	<b>3,165</b>	<b>1,902</b>	<b>1,211</b>	<b>19,941</b>
Total					
Certificates of deposit	<b>35,258</b>	<b>7,033</b>	<b>5,919</b>	<b>2,204</b>	<b>50,414</b>
Time deposits:					
□ banks	<b>52,233</b>	<b>3,597</b>	<b>3,097</b>	<b>4,603</b>	<b>63,530</b>
□ customers	<b>141,619</b>	<b>9,250</b>	<b>5,551</b>	<b>8,329</b>	<b>164,749</b>
	<b>229,110</b>	<b>19,880</b>	<b>14,567</b>	<b>15,136</b>	<b>278,693</b>

*The geographical analysis of deposits is based on the location of the office in which the deposits are recorded and excludes balances with HSBC companies. The majority of certificates of deposit and time deposits are in amounts of US\$100,000 and over or the equivalent in other currencies.*

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## Off-balance sheet arrangements and special purpose entities

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*(Audited)*

This section contains disclosures about off-balance sheet arrangements and special purpose entities (SPEs) that have been included in HSBC's consolidated balance sheet.

### Special purpose entities (including on and off-balance sheet arrangements)

HSBC enters into certain transactions with customers in the ordinary course of business which involve the establishment of SPEs to facilitate customer transactions.

HSBC structures that utilise SPEs are authorised centrally upon establishment to ensure appropriate purpose and governance. The activities of SPEs administered by HSBC are closely monitored by senior management. The use of SPEs is not a significant part of HSBC's activities and HSBC is not reliant on the use of SPEs for any material part of its business operations or profitability. HSBC's involvements with SPE transactions are described below.

#### HSBC-sponsored vehicles

HSBC sponsors the formation of entities to accomplish certain narrow and well-defined objectives, such as securitisations of financial assets or to effect a lease. HSBC consolidates these SPEs when the substance of the relationship indicates that HSBC controls the SPE. In assessing control, all relevant factors need to be considered. Such factors may have qualitative and quantitative aspects. For example:

Qualitative factors. In substance:

- the activities of the SPE are being conducted on behalf of HSBC according to HSBC's specific business needs so that it obtains benefit from the SPE's operation. This might be evidenced, for example, by HSBC providing a significant level of support to the SPE; and
- HSBC has the decision-making powers to obtain the majority of the benefits of the activities of the SPE.

Quantitative factors – hereinafter referred to as "the majority of risks and rewards of ownership". In substance:

- HSBC has rights to obtain the majority of the benefits of the SPE and therefore may be exposed to risks incidental to the activities of the SPE; and
- HSBC retains the majority of the residual or ownership risks related to the SPE or its assets in order to obtain benefits from its activities.

In a number of cases, these SPEs are accounted for off-balance sheet under IFRSs where HSBC does not have the majority of the risks and rewards of ownership of the SPE. However in certain circumstances, after careful consideration of the facts, HSBC consolidates an SPE where, although it does not obtain the majority of risks and rewards of ownership, the qualitative features of HSBC's involvement indicate that, in substance, the activities of the SPE are being conducted on behalf of HSBC.

HSBC reassesses the required consolidation accounting tests whenever there is a change in the substance of a relationship between HSBC and an SPE, for example, when there is a change in HSBC's involvement or there is a change in the governing rules, contractual arrangements or capital structure of the SPE. The most significant categories of SPEs are discussed in more detail below.

#### Structured investment vehicles

Structured investment vehicles (SIVs) are SPEs which are established to invest in diversified portfolios of interest-earning assets, generally comprising asset-backed debt securities and other debt securities issued by financial institutions or corporates. SIVs are typically funded through the issue of CP, medium-term notes or

other senior debt (collectively referred to as "senior debt"), repo financing, and subordinated income or mezzanine notes (commonly referred to as "capital notes"). The sponsor of the SIV would typically provide only limited liquidity support to the senior debt investors through committed liquidity facilities.

SIVs are structured to provide investors with the opportunity to invest in a range of assets depending on their risk preference. Senior debt issued by SIVs is structured to be highly rated and the SIVs are managed within strict operating criteria. Liquidity in SIVs is primarily managed by rolling over debt at maturity or, if that is not possible, by the sale of assets to provide protection to senior debt holders. SIVs are typically subject to market value and net asset value triggers which underpin the external credit ratings of the senior debt. The liquidity risk in SIVs is managed by controlling the maximum cumulative cash outflow occurring in defined time periods.

HSBC sponsored the establishment of two SIVs, Cullinan and Asscher in August 2005 and May 2007, respectively, which were successful in obtaining funding from investors, who subscribed for senior

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*Other financial information > Off balance sheet arrangements and SPEs*

debt and capital notes. These SIVs were not consolidated on inception because HSBC did not have the majority of risks and rewards of ownership and it was not anticipated that HSBC would provide significant funding to these SIVs. HSBC is the manager for both SIVs, and was committed from inception to provide limited support by way of contractually committed liquidity lines on normal commercial terms.

The maximum size of each SIV during 2007, as measured by the par value of the SIV's total assets, together with the maximum exposure HSBC had under its committed liquidity facilities, was as follows:

	<b>Maximum size of SIV US\$bn</b>	<b>HSBC committed liquidity facility US\$bn</b>
Cullinan	<b>42.2</b>	<b>0.50</b>
Asscher	<b>8.7</b>	<b>0.25</b>
	<b>50.9</b>	<b>0.75</b>

From mid-August 2007, liquidity in the wholesale markets became severely disrupted, principally as a result of valuation concerns over securities linked to US sub-prime mortgage loans, resulting in funding difficulties for many SPEs, including SIVs. At the outset, bank-sponsored SIVs were less affected and, initially, Cullinan and Asscher continued to fund themselves in the CP market.

By the end of the third quarter of 2007, it became clear that the disruption in the supply of CP funding for the SIV market was not a temporary situation and, as a consequence, by the end of September 2007, HSBC provided US\$16.7 billion of funding to Cullinan and Asscher in the form of repos, CP purchases and the acquisition of US\$4.1 billion of assets at fair value from Cullinan.

During the same period, the market value of certain assets held by Cullinan and Asscher fell because the market liquidity position had weakened and credit spreads had widened.

From October 2007, all the capital note holders of Cullinan were given the option to switch their capital note holdings for a share of the assets of the SIV. As part of this offer, HSBC switched its entire holding in Cullinan capital notes for Cullinan assets. The par value and market value of the assets purchased amounted to US\$709 million and US\$684 million respectively. The consideration paid comprised HSBC's capital note holding with an aggregate par value of US\$50 million (fair value

US\$25 million) and cash of US\$659 million. In addition, in January 2008, HSBC purchased Cullinan capital notes from existing holders with a par value of US\$171 million (fair value US\$39 million), and then exchanged such Cullinan capital notes, together with cash of US\$2,302 million, for Cullinan assets with a par value of US\$2,473 million and a market value of US\$2,341 million.

In November 2007, HSBC announced its intention to provide investors in Cullinan and Asscher with the option to exchange their capital notes for notes issued by one or more new SPEs, with term funding and liquidity to be provided by HSBC.

Based on a careful evaluation of all the facts and circumstances, HSBC concluded that this announcement had substantively changed the relationship HSBC had with these SIVs such that HSBC was required to consolidate these SIVs from November 2007.

After the announcement in November 2007, two new SPEs, an asset-backed commercial paper conduit and a term funding vehicle, were established in respect of Cullinan. Each SPE has been set up so that its continuing operation is not as sensitive as Cullinan to market value fluctuations in its underlying assets. These SPEs will be funded either by CP backed by a 100 per cent liquidity facility provided by HSBC, or by term funding provided by HSBC. This reorganisation addresses the two main challenges for the SIV sector which could force asset sales: the inability to fund in the CP markets, and the sensitivity of the continuing operation of SIVs to changes in the market value of their underlying assets.

The new SPEs have agreed to purchase Cullinan's assets, over a time period that is anticipated to coincide with the maturity of Cullinan's senior debt. The purchase price was based on the fair value of Cullinan's assets as at 21 January 2008.

In January 2008, investors in the capital notes issued by Cullinan were given the option to exchange their existing capital notes for the capital notes in the new SPEs.

On 13 February 2008, the par value of the capital notes outstanding in Cullinan amounted to US\$1.9 billion. On this date, all the holders of the remaining capital notes in Cullinan elected to exchange their existing holding for capital notes in the new SPEs. The holders of such capital notes will bear the risks of any losses arising in the new SPEs

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up to the par value of their holding in the capital notes.

The holders of the capital notes in Asscher continue to bear the risk of any first losses in the assets held by the SIV. It is proposed to reorganise Asscher following the completion of the Cullinan exchange.

The effect of consolidating Cullinan and Asscher on HSBC's balance sheet was to include US\$42.5 billion of both assets and liabilities from November 2007. This included capital notes of US\$38.1 billion, holdings of CP of US\$4.7 billion and repos of US\$8.5 billion previously recognised on HSBC's balance sheet.

An analysis of the assets held by Cullinan and Asscher at 31 December 2007 and 2006 is set out below.

#### *Cullinan □ Ratings analysis of assets*

	<b>2007</b>	2006
	<b>US\$bn</b>	US\$bn
<b>S&amp;P ratings</b>		
AAA	<b>22.2</b>	23.1
AA	<b>2.9</b>	2.3
A	<b>3.1</b>	3.5
BBB	<b>0.1</b>	0.1
	<hr/>	<hr/>
Total investments	<b>28.3</b>	29.0
Cash and other assets	<b>5.0</b>	1.5
	<hr/>	<hr/>
Total assets	<b>33.3</b>	30.5
	<hr/>	<hr/>

#### *Cullinan □ Composition of asset portfolio*

	<b>2007</b>	2006
	<b>US\$bn</b>	US\$bn
<b>Asset class</b>		
<b>Structured finance</b>		
Residential mortgage-backed securities	<b>9.9</b>	11.9
Commercial mortgage-backed securities	<b>3.7</b>	3.9
Collateralised debt obligations	<b>3.8</b>	3.0
Student loan securities	<b>2.2</b>	2.3
Home equity lines of credit securities	<b>1.3</b>	2.0
Vehicle finance loans securities	<b>0.3</b>	0.4
Credit loan securities	<b>0.1</b>	0.2
Other asset-backed securities	<b>4.5</b>	0.8
	<hr/>	<hr/>
Total structured finance assets	<b>25.8</b>	24.5
	<hr/>	<hr/>
<b>Finance</b>		
Commercial bank debt securities and deposits	<b>6.3</b>	5.1
Investment bank debt securities	<b>0.7</b>	0.6
Finance company debt securities	<b>0.5</b>	0.3
	<hr/>	<hr/>
Total bank and finance company assets	<b>7.5</b>	6.0
	<hr/>	<hr/>

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Total assets	<b>33.3</b>	30.5
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These assets included US\$2 billion (2006: US\$2.7 billion) of exposure to US sub-prime mortgages, all of which are rated AAA.

*Cullinan □ Total assets by balance sheet classification*

	<b>2007 US\$bn</b>
Derivative assets	<b>0.2</b>
Loans and advances to banks	<b>2.4</b>
Financial investments	<b>30.5</b>
Other assets	<b>0.2</b>
	<b>33.3</b>

*Cullinan □ Weighted-average maturity of assets*

	<b>2007 US\$bn</b>	2006 US\$bn
0-6 months	<b>6.1</b>	1.5
6-12 months	<b>1.6</b>	1.0
Greater than 12 months	<b>25.6</b>	28.0
Total assets	<b>33.3</b>	30.5

The weighted average life of the portfolio at 31 December 2007 was 4 years (2006: 3.63 years).

*Cullinan □ Funding structure*

	<b>Total US\$bn</b>	<b>Provided by HSBC US\$bn</b>
<b>2007</b>		
Capital notes	<b>1.0</b>	□
Commercial paper	<b>5.3</b>	<b>2.3</b>
Medium-term notes	<b>19.7</b>	<b>3.8</b>
Term repos executed	<b>7.1</b>	<b>7.1</b>
	<b>33.1</b>	<b>13.2</b>
<b>2006</b>		
Capital notes	1.8	□
Commercial paper	9.1	□
Medium-term notes	19.2	□
	30.1	□

The weighted average life of CP funding was 0.56 years (2006: 0.13 years) and the weighted average life of medium-term note funding was 1.13 years (2006: 0.64 years).

*Asscher* □ Ratings analysis of assets

	<b>2007</b>
	<b>US\$bn</b>
<b>S&amp;P ratings</b>	
AAA	<b>6.1</b>
AA	<b>0.4</b>
A	<b>0.3</b>
	<hr/>
Total investments	<b>6.8</b>
Cash and other assets	<b>0.6</b>
	<hr/>
Total assets	<b>7.4</b>
	<hr/>



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*Asscher □ Composition of asset portfolio*

	<b>2007 US\$bn</b>
<b>Asset class</b>	
<b>Structured finance</b>	
Residential mortgage-backed securities	3.0
Commercial mortgage-backed securities	1.3
Collateralised debt obligations	1.1
Student loan securities	0.4
Home equity lines of credit securities	0.3
Credit loan securities	0.1
Other asset-backed securities	0.1
	<hr/>
Total structured finance assets	6.3
	<hr/>
<b>Finance</b>	
Commercial bank debt securities and deposits	1.0
Investment bank debt securities	0.1
Finance company debt securities	□
	<hr/>
Total bank and finance company assets	1.1
	<hr/>
Total assets	7.4
	<hr/>

These assets included US\$42 million of exposure to US sub-prime mortgages, all of which are rated AAA.

*Asscher □ Total assets by balance sheet classification*

	<b>2007 US\$bn</b>
Derivative assets	0.1
Loans and advances to banks	0.7
Financial investments	6.6
	<hr/>
	7.4
	<hr/>

*Asscher □ Weighted-average maturity of assets*

**2007**  
**US\$bn**

0-6 months	<b>0.8</b>
6-12 months	<b>0.6</b>
Greater than 12 months	<b>6.0</b>
Total assets	<b>7.4</b>

The weighted average life of the portfolio at 31 December 2007 was 3.7 years.

*Asscher* □ *Funding structure*

	<b>2007</b>	
	<b>Total</b>	<b>Provided</b>
	<b>US\$bn</b>	<b>by HSBC</b>
		<b>US\$bn</b>
Mezzanine notes	<b>0.3</b>	□
Commercial paper	<b>2.0</b>	<b>0.1</b>
Medium-term notes	<b>3.5</b>	<b>1.5</b>
Term repos executed	<b>1.6</b>	<b>1.1</b>
	<b>7.4</b>	<b>2.7</b>

The weighted average life of CP funding liabilities was 0.44 years and the weighted average life of medium-term note funding liabilities was 1.03 years.

### Money market funds

HSBC has established and manages a number of money market funds which provide customers with tailored investment opportunities. These SPEs have narrow and well-defined objectives and typically HSBC does not have any holdings in the SPEs of sufficient size to represent the majority of the risks and rewards of ownership.

In aggregate, HSBC had established money market funds which had total assets of US\$109 billion at 31 December 2007 (2006: US\$93 billion).

These are the main sub-categories of money market funds:

- US\$57 billion (2006: US\$41 billion) in Constant Net Asset Value (□CNAV□) funds, which invest in shorter-dated and highly-rated money market securities with the objective of providing investors with a highly liquid and secure investment;
- US\$12 billion (2006: US\$15 billion) in French domiciled *dynamique* (□dynamic□) funds and Irish □enhanced□ funds, together Enhanced Variable Net Asset Value (□Enhanced VNAV□) funds, which invest in longer-dated money market securities to provide investors with a higher return than traditional money market funds; and
- US\$40 billion (2006: US\$37 billion) in various other money market funds, Variable Net Asset Value (□VNAV□) funds including funds domiciled in Brazil, France, India, Mexico and other countries.

These money market funds invest in a diverse portfolio of highly-rated debt instruments, including limited holdings in instruments issued by SIVs. At 31 December 2007, these funds□ exposure to SIVswas US\$3.9 billion (2006: US\$6.8 billion).

*CNAV funds*

CNAV funds price their assets on an amortised cost basis, subject to the amortised book value of the portfolio being within 50 basis points of its market value. This enables CNAV funds to create and liquidate shares in the fund at a constant price. If the amortised value of the portfolio were to vary by more than 50 basis points from its market value, the

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CNAV fund would be required to price its assets at market value, and consequently would no longer be able to create or liquidate shares at a constant price. This is commonly known as "breaking the buck".

HSBC's CNAV funds hold senior notes issued by a number of SIVs and, due to current market liquidity conditions and consequential actions of the rating agencies, the market value of this SIV paper has deteriorated. This has caused the CNAV funds to record unrealised losses on their SIV investments. While the majority of these SIVs are bank-sponsored, and are not judged to be impaired, there are holdings in three independent SIVs which have experienced greater difficulties; two of these, in which HSBC's CNAV funds have invested US\$0.3 billion, were placed in enforcement in early 2008; the process by which the winding down of the independent SIVs and repaying secured creditors begins.

The deterioration in the market value of holdings of SIV paper raised the possibility that certain CNAV funds would be forced to realise liquid assets to meet potential redemptions. To help address this potential impact, on 24 December 2007, HSBC provided two letters of limited indemnity, capped at US\$33 million and £4 million (US\$8 million) respectively, in relation to certain holdings of SIV assets of two of its CNAV funds with total assets under management ("AUM") at 31 December 2007 of US\$27.1 billion. These limited indemnities did not result in HSBC consolidating these funds because HSBC was not exposed to the majority of the risks and rewards of ownership and the investors of the funds continue to bear the first loss. Separately, in December 2007, HSBC acquired US\$0.3 billion of SIV paper at fair value from these CNAV funds.

Since 31 December 2007, HSBC has provided two additional letters of limited indemnity capped at US\$33 million and £2 million (US\$4 million) respectively, in relation to certain holdings of SIV assets of a further two CNAV funds with AUM at 31 December 2007 of US\$8.7 billion. HSBC is not exposed to the majority of risks and rewards of ownership of the funds.

HSBC has continued to create and liquidate shares in all its CNAV funds at a constant price.

*Enhanced VNAV funds*

Enhanced VNAV funds price their assets on a fair value basis and consequently prices may change from one day to the next. These funds pursue an "enhanced" investment strategy, as part of which

investors accept greater credit and duration risk in the expectation of higher returns.

Money market activities are highly developed in France due to the historical restriction on the payment of interest on current accounts, and the search for enhanced yields has resulted in sophisticated money market funds which are essentially used as an alternative to cash. However, since July 2007, French dynamic money market funds have experienced unprecedented redemption requests caused by the market's lack of confidence in funds containing exposure primarily to US sub-prime assets. In August 2007, the decision by two French institutions to suspend withdrawals from certain asset-backed securities funds caused a general acceleration of redemption requests on dynamic money market funds.

In the third quarter of 2007, HSBC acquired underlying assets and shares in two of its dynamic money market funds of €1.2 billion (US\$1.8 billion) and €0.6 billion (US\$0.9 billion) respectively to fund asset redemptions. No additional shares were acquired in the fourth quarter. HSBC's aggregate holding in these funds at 31 December 2007 was €0.9 billion (US\$1.3 billion). The total AUM of these two funds at 31 December 2007 was €2.1 billion (US\$3.1 billion). These funds were not consolidated by HSBC at 31 December 2007 because the acquisition of additional shares in these funds did not expose HSBC to the majority of risks and rewards of ownership. However, post year end, one of the funds has been consolidated by HSBC as a result of continued redemptions by unit holders which caused HSBC's percentage holding in the funds to increase to a level where HSBC would obtain the majority of risks and rewards of ownership.

A further Enhanced VNAV fund experienced high shareholder redemptions in the fourth quarter of 2007 which depleted its stock of liquid assets, reducing its ability to meet further redemption payments. During November 2007, HSBC made two purchases of shares in the fund for US\$0.3 billion and US\$0.1 billion, respectively, to fund asset redemptions. This resulted in HSBC consolidating the fund because its resultant holding of 52 per cent

represents the majority of risks and rewards of ownership.

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HSBC HOLDINGS PLC

**Report of the Directors: Financial Review**

(continued)

*Other financial information > Off balance sheet arrangements and SPEs*

*Total assets of HSBC's money market funds*

	<b>2007</b>	2006
	<b>US\$bn</b>	US\$bn
CNAV funds	<b>56.8</b>	40.9
Enhanced VNAV funds	<b>11.9</b>	15.2
VNAV funds	<b>40.2</b>	36.9
	<b>108.9</b>	93.0

*Total assets of HSBC's money market funds, which are off-balance sheet*

	<b>2007</b>	2006
	<b>US\$bn</b>	US\$bn
CNAV funds	<b>56.8</b>	40.9
Enhanced VNAV funds	<b>6.2</b>	13.1
VNAV funds	<b>40.2</b>	36.9
	<b>103.2</b>	90.9

HSBC's financial investments in off-balance sheet money market funds at 31 December 2007 amounted to US\$2.9 billion (2006: US\$0.7 billion). These assets have been classified as available-for-sale securities and measured at fair value.

Total assets of HSBC's money market funds which are on-balance sheet at 31 December 2007 amounted to US\$5.7 billion (2006: US\$2.1 billion). These assets have been measured at fair value; US\$0.7 billion (2006: nil) were classified as trading assets, and US\$5 billion (2006: US\$2.1 billion) were designated at fair value.

**Non-money market investment funds**

HSBC has also established a large number of non-money market funds to enable customers to invest in a range of assets, typically equities and debt securities. At the launch of a fund HSBC, as fund manager, typically provides a limited amount of initial capital known as "seed capital" to enable the fund to start purchasing assets. These holdings are normally redeemed over time. The majority of these funds are off-balance sheet because in view of HSBC's limited economic interest, HSBC does not have the majority of the risks and rewards of ownership.

*Total assets of HSBC's non-money market funds*

	<b>2007</b>	2006
	<b>US\$bn</b>	US\$bn

**Assets under management**

Specialist funds	<b>132.0</b>	123.3
Local Investment Management funds	<b>108.8</b>	89.9
Multi-manager	<b>30.4</b>	22.3
	<b>271.2</b>	235.5

*Total assets of HSBC's non-money market funds which are off-balance sheet*

	<b>2007</b>	2006
	<b>US\$bn</b>	US\$bn
Specialist funds	<b>131.0</b>	122.9
Local Investment Management funds	<b>105.7</b>	88.0
Multi-manager	<b>30.4</b>	22.3
	<b>267.1</b>	233.2

HSBC's financial investments in off-balance sheet non-money market funds at 31 December 2007 amounted to US\$2.7 billion (2006: US\$2.0 billion). These assets have been classified as available-for-sale securities and measured at fair value.

*Total assets of HSBC's non-money market funds, which are on-balance sheet*

	<b>2007</b>	2006
	<b>US\$bn</b>	US\$bn
Specialist funds	<b>1.0</b>	0.4
Local Investment Management funds	<b>3.1</b>	1.9
	<b>4.1</b>	2.3

*Total assets of HSBC's non-money market funds which are on-balance sheet, by balance sheet classification*

	<b>2007</b>	2006
	<b>US\$bn</b>	US\$bn
Cash	<b>0.4</b>	0.2
Trading assets	<b>0.5</b>	0.2
Financial instruments designated at fair value	<b>3.0</b>	1.8
Financial investments	<b>0.2</b>	0.1
	<b>4.1</b>	2.3

**Conduits**

HSBC sponsors and manages two types of conduits which issue CP; multi-seller conduits and securities investment conduits. HSBC consolidated these conduits from inception because it is exposed to the majority of risks and rewards of ownership.

**Multi-seller conduits** have been established for the purpose of providing alternative sources of financing to HSBC's clients, for example, in respect of discrete pools of vehicle finance loan receivables.

The multi-seller conduits purchase or fund interests in diversified pools of third party assets, which are financed by the issuance of CP. The cash flows received by the conduits are utilised to service payments to clients and to provide a commercial rate of return for HSBC. CP issued by the multi-seller



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conduits carries highly liquid short-term ratings, and benefits from liquidity facilities typically provided by HSBC. HSBC also provides secondary credit enhancements under the terms specified in the relevant programme documentation. HSBC's multi-seller conduits are Regency Assets Limited (["Regency"]), Bryant Park Funding LLC (["Bryant Park"]), Abington Square Funding LLC (["Abington Square"]), and Performance Trust.

Due to lack of investor interest from the middle of 2007 in extendable CP, including that issued by Abington Square, HSBC provided finance to the conduit by purchasing the majority of its extendable CP from investors. In February 2008, the remaining assets within the conduit were refinanced and the CP repaid. The other multi-seller conduits are supported by liquidity facilities typically provided by HSBC. While these facilities do not provide for liquidity payments against defaulted assets they will in all cases provide for repayment of 100 per cent of CP that is covered by non-defaulted receivables.

Performance Trust was originally consolidated by HSBC, and later deconsolidated because HSBC retired the programme wide credit enhancement and the first loss note was sold to a third party during 2006. However, due to lack of liquidity in the market, Performance Trust experienced funding difficulties in the fourth quarter of 2007 and HSBC purchased Performance Trust's CP as it became due. This resulted in HSBC consolidating the fund because its resultant holding of 83 per cent represents the majority of risks and rewards of ownership.

**Securities investment conduits** purchase highly rated asset-backed securities and facilitate tailored investment opportunities for HSBC's investor clients. HSBC's securities investment conduit is Solitaire Funding Limited (["Solitaire"]).

An analysis of the assets held by Solitaire at 31 December 2007 and 2006 is set out below.

*Solitaire [ Ratings analysis of assets*

	<b>2007</b>	2006
	<b>US\$bn</b>	US\$bn
<b>S&amp;P Ratings</b>		
AAA	<b>20.8</b>	20.2
Total investments	<b>20.8</b>	20.2
Cash and other assets	<b>0.8</b>	0.2
Total assets	<b>21.6</b>	20.4

*Solitaire [ Composition of asset portfolio*

	<b>2007</b>	2006
	<b>US\$bn</b>	US\$bn
<b>Asset class</b>		
<b>Structured finance</b>		
Residential mortgage-backed securities	<b>8.7</b>	9.4
Commercial mortgage-backed securities	<b>3.7</b>	3.1
Collateralised debt obligations	<b>3.1</b>	2.5
Student loans securities	<b>3.5</b>	3.0
Home equity lines of credit securities	<b>0.6</b>	0.8
Vehicle finance loans securities	<b>0.1</b>	0.2
Credit loans securities	<b>0.3</b>	0.3
Other asset-back securities	<b>1.0</b>	0.9

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Total structured finance assets	<b>21.0</b>	20.2
<b>Finance</b>		
Commercial bank debt securities and deposits	<b>0.6</b>	0.2
Total bank and finance company assets	<b>0.6</b>	0.2
Total assets	<b>21.6</b>	20.4

These assets include US\$1.1 billion (2006: US\$1.8 billion) of exposure to US sub-prime mortgages, all of which are rated AAA.

*Solitaire* □ *Total assets by balance sheet classification*

	<b>2007</b>	2006
	<b>US\$bn</b>	US\$bn
Financial instruments designated at fair value	<b>0.1</b>	0.1
Derivative assets	<b>0.1</b>	□
Loans and advances to banks	<b>0.2</b>	□
Financial investments	<b>20.6</b>	20.1
Other assets	<b>0.6</b>	0.2
	<b>21.6</b>	20.4

*Solitaire* □ *Funding structure*

	<b>Total</b>	<b>Provided</b>
	<b>US\$bn</b>	<b>by HSBC</b>
		<b>US\$bn</b>
<b>2007</b>		
Commercial paper	<b>23.0</b>	<b>7.8</b>
<b>2006</b>		
Commercial paper	20.2	□

The consolidation of HSBC's conduits resulted in HSBC consolidating assets of US\$37.4 billion (2006: US\$35.0 billion, excluding Performance Trust).

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HSBC HOLDINGS PLC

**Report of the Directors: Financial Review**

(continued)

*Other financial information > Off balance sheet arrangement and SPEs*

*Total assets of HSBC's conduits by balance sheet classification, which are on-balance sheet*

	<b>2007</b>	2006
	<b>US\$bn</b>	US\$bn
Financial instruments designated at fair value	<b>0.1</b>	0.1
Derivative assets	<b>0.1</b>	□
Loans and advances to banks	<b>0.2</b>	□
Loans and advances to customers	<b>14.9</b>	9.6
Financial investments	<b>21.1</b>	24.6
Other assets	<b>1.0</b>	0.7
	<b>37.4</b>	35.0

**Securitisations**

HSBC uses SPEs to securitise customer loans and advances it has originated mainly in order to diversify its sources of funding, and for capital efficiency. In such cases, the loans and advances are transferred by HSBC to the SPEs for cash, and the SPEs issue debt securities to investors. Credit enhancements are used to obtain investment grade ratings on the senior debt issued by the SPEs.

Except for one securitisation, with total assets of US\$0.5 billion (2006: US\$0.5 billion), where the SPE has not been consolidated because HSBC does not have the majority of risks and rewards of ownership, these SPEs are consolidated by HSBC. HSBC also established term securitisation programmes in the US and Germany where third party loans are securitised. The majority of these vehicles are not consolidated by HSBC as it is not exposed to majority of risks and rewards of ownership in the SPEs.

HSBC also uses SPEs for capital management purposes in respect of its originated customer loans and advances, where only the credit risk associated with the customer loans and advances is transferred by HSBC to the SPE using credit derivatives. These securitisations are commonly known as synthetic securitisations. These SPEs are consolidated where HSBC is exposed to the majority of risks and rewards of ownership.

*Total assets of HSBC's securitisations, by balance sheet classification, which are on-balance sheet*

	<b>2007</b>	2006
	<b>US\$bn</b>	US\$bn
Trading assets	<b>3.6</b>	0.3
Loans and advances to customers	<b>70.5</b>	68.7
Financial investments	<b>0.1</b>	0.2
Other assets	<b>1.5</b>	3.0
Derivatives	<b>0.1</b>	□

75.8	72.2
------	------

Total assets of HSBC's securitisations, which are off-balance sheet

	<b>2007</b>	2006
	<b>US\$bn</b>	US\$
HSBC originated assets	<b>0.5</b>	0.5
Non-HSBC originated assets (term securitisation programmes)	<b>17.3</b>	17.3
	<b>17.8</b>	17.8

HSBC's financial investments in off-balance sheet securitisations at 31 December 2007 amounted to US\$0.7 billion (2006: US\$0.7 billion). These assets include assets that have been securitised by HSBC under arrangements in which HSBC retains a continuing involvement in such assets which are classified as available-for-sale securities and measured at fair value. Further details are provided in Note 20 on the Financial Statements.

### Other

HSBC also establishes SPEs in the normal course of business for a number of purposes, for example, structured credit transactions for customers to provide finance to public and private sector infrastructure projects, and for asset and structured finance (ASF) transactions.

### Structured credit transactions

HSBC provides structured credit transactions to third party professional and institutional investors who wish to obtain exposure, sometimes on a leveraged basis, to a reference portfolio of debt instruments. The investors obtain the risks and rewards of the relevant reference portfolios by purchasing notes issued by the SPEs. The SPEs enter into contracts with HSBC, generally in the form of derivatives, in order to pass the risks and rewards of the reference portfolios to the SPEs. HSBC's risk in relation to the derivative contracts with the SPEs is managed within HSBC's trading market risk framework (see Market Risk Management on page 248).

The transactions are facilitated through SPEs in order that the notes issued to the investors can be rated. The SPEs are not consolidated by HSBC because the investors bear substantially all the risks and rewards of ownership through the notes. The exception would be in circumstances where HSBC itself holds a majority of the notes in particular SPEs.

The total fair value of liabilities (notes issued and derivatives) in structured credit transaction SPEs amounted to US\$23.6 billion at 31 December 2007 (2006: US\$7.9 billion). These amounts include

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US\$0.1 billion (2006: US\$0.7 billion) in SPEs that were consolidated by HSBC.

### Other uses of SPEs

HSBC participates in [Public-Private Partnerships] to provide financial support for infrastructure projects initiated by government authorities. The funding structure is commonly achieved through the use of SPEs. HSBC consolidates these SPEs where it is exposed to the majority of risks and rewards of the vehicles.

HSBC's ASF business specialises in leasing and arranging finance for aircraft and other physical assets, which it is customary to ring-fence through the use of SPEs, and in structured loans and deposits where SPEs introduce cost efficiencies. HSBC consolidates these SPEs where the substance of the relationship indicates that HSBC controls the SPE.

HSBC's risks and rewards of ownership in these SPEs are in respect of its on-balance sheet assets and liabilities.

### Third party sponsored SPEs

HSBC's exposure to third party sponsored SIVs, conduits and securitisations have arisen through normal banking arrangements on standard market terms. HSBC did not provide any credit enhancement to third party SIVs, conduits and securitisations.

### HSBC's commitments under liquidity facilities to third party SIVs, conduits and securitisations

	<b>Commit- ments US\$bn</b>	<b>Drawn US\$bn</b>
<b>2007</b>		
Third party SIVs	<b>0.3</b>	□
Third party conduits	<b>5.3</b>	<b>0.4</b>
Third party securitisations	<b>0.5</b>	□
	<b>6.1</b>	<b>0.4</b>
<b>2006</b>		
Third party SIVs	<b>0.2</b>	□
Third party conduits	<b>5.4</b>	□
Third party securitisations	<b>0.5</b>	□
	<b>6.1</b>	□

### Other exposures to third party SIVs, conduits and securitisations where a liquidity facility has been provided

	<b>2007 US\$bn</b>	2006 US\$
Derivative assets	<b>0.2</b>	0.1

### Other off-balance sheet arrangements and commitments

Financial guarantees, letters of credit and similar undertakings

Note 41 on the Financial Statements describes various types of guarantees and discloses the maximum potential future payments under such arrangements. Credit risk associated with all forms of guarantees is assessed in the same manner as for on-balance sheet credit advances and, where necessary, provisions for assessed impairment are included in [Other provisions].

Commitments to lend

Undrawn credit lines are disclosed in Note 41 on the Financial Statements. The majority by value of undrawn credit lines arise from [open to buy] lines on personal credit cards, advised overdraft limits and other pre-approved loan products, and mortgage offers awaiting customer acceptance. HSBC generally has the right to change or terminate any conditions of a personal customer's overdraft, credit card or other credit line upon notification to the customer. In respect of corporate commitments to lend, in most cases HSBC's position will be protected through restrictions on access to funding in the event of material adverse change.

**Leveraged finance transactions**

Loan commitments in respect of leveraged finance transactions are accounted for as derivatives where it is HSBC's intention to sell the loan after origination. As at 31 December 2007, HSBC's commitments in respect of leveraged finance transactions were US\$8.9 billion, of which US\$6.0 billion were funded and US\$2.9 billion were un-funded. During 2007, losses of US\$195 million were recognised in trading income relating to transactions priced prior to the dislocation in the market. Transactions priced subsequent to the widening of credit spreads have not resulted in any material net write-downs.

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HSBC HOLDINGS PLC

## Report of the Directors: Financial Review

(continued)

*Disclosure controls /Management's assessment of internal controls*

### Disclosure controls

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The Group Chairman and Group Finance Director, with the assistance of other members of management, carried out an evaluation of the effectiveness of the design and operation of HSBC Holdings' disclosure controls and procedures as of 31 December 2007. Based upon that evaluation, the Group Chairman and Group Finance Director concluded that HSBC's disclosure controls and procedures as of 31 December 2007 were effective to provide reasonable assurance that information required to be disclosed in the reports which the company files and submits under the US Securities Exchange Act of 1934, as amended, is recorded, processed, summarised and reported as and when required. There are inherent limitations to the effectiveness of any system of disclosure controls and procedures, including the possibility of human error and the circumvention or overriding of the controls and procedures. Accordingly, even effective disclosure controls and procedures can only provide reasonable assurance of achieving their control objectives.

There has been no change in HSBC Holdings' internal control over financial reporting during the year ended 31 December 2007 that has materially affected, or is reasonably likely to materially affect, HSBC Holdings' internal control over financial reporting.

### Management's assessment of internal controls

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Management is responsible for establishing and maintaining an adequate internal control structure and procedures for financial reporting, and has completed an assessment of the effectiveness of the Group's internal control over financial reporting as of 31 December 2007. In making the assessment, management used the framework for Director's internal control evaluation contained within the Combined Code (The Revised Turnbull Guidance), as well as the criteria established by the Committee of Sponsoring Organisations of the Treadway Commission (COSO) in Internal Control-Integrated Framework.

Based on the assessment performed, management concluded that as at 31 December 2007, the Group's internal control over financial reporting was effective.

KPMG Audit Plc, which has audited the consolidated financial statements of the Group for the year ended 31 December 2007, has also audited the effectiveness of the Group's internal control over financial reporting under Auditing Standard No.5 of the Public Company Accounting Oversight Board (United States) as stated in their report on pages 334 and 335.

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HSBC HOLDINGS PLC

## Report of the Directors: The Management of Risk

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1 Unaudited.

2 Audited.

3 Audited where indicated.

### Regulation and supervision

(Unaudited)

With listings of its ordinary shares in London, Hong Kong, New York, Paris and Bermuda, HSBC Holdings complies with the relevant requirements for listing and trading on each of these exchanges. In the UK, these are



the Listing Rules of the Financial Services Authority (‘‘FSA’’); in Hong Kong, The Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited (‘‘HKSE’’); in the US, where the shares are traded in the form of ADSs, HSBC Holdings’ shares are registered with the US Securities and Exchange Commission (‘‘SEC’’). As a consequence of its US listing, HSBC Holdings is also subject to the reporting and other requirements of the US Securities Act of 1933, as amended, the Securities Exchange Act of 1934, as amended, and the New York Stock Exchange’s (‘‘NYSE’’) Listed Company Manual, in each case as applied to foreign private issuers. In France and Bermuda, HSBC Holdings is subject to the listing rules of Euronext, Paris and the Bermuda Stock Exchange respectively, applicable to companies with secondary listings.

A statement of HSBC’s compliance with the code provisions of the Combined Code on Corporate Governance issued by the Financial Reporting Council and with the Code on Corporate Governance Practices in Appendix 14 to the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited is set out in the ‘‘Report of the Directors: Governance’’ on page 289.

HSBC’s operations throughout the world are regulated and supervised by approximately 510 different central banks and regulatory authorities in those jurisdictions in which HSBC has offices, branches or subsidiaries. These authorities impose a variety of requirements and controls designed to improve financial stability and the transparency of financial markets and their contribution to economic growth. These regulations and controls cover, *inter alia*, capital adequacy, depositor protection, market liquidity, governance standards, customer protection (for example, fair lending practices, product design, and marketing and documentation standards), and social responsibility obligations (for example, anti-money laundering and anti-terrorist financing measures). In addition, a number of countries in which HSBC operates impose rules that affect, or place limitations on, foreign or foreign-owned or controlled banks and financial institutions. The rules include restrictions on the opening of local offices, branches or subsidiaries and the types of banking and non-banking activities that may be conducted by those local offices, branches or subsidiaries;

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restrictions on the acquisition of local banks or regulations requiring a specified percentage of local ownership; and restrictions on investment and other financial flows entering or leaving the country. The supervisory and regulatory regimes of the countries where HSBC operates will determine to some degree HSBC's ability to expand into new markets, the services and products that HSBC will be able to offer in those markets and how HSBC structures specific operations.

The FSA supervises HSBC on a consolidated basis. In addition, each operating bank, finance company or insurance operation within HSBC is regulated by local supervisors. The primary regulatory authorities are those in the UK, Hong Kong and the US, the Group's principal areas of operation.

In June 2004, the Basel Committee on Banking Supervision introduced a new capital adequacy framework to replace the 1988 Basel Capital Accord in the form of a final Accord (commonly known as "Basel II"). Details of the EU's implementation of Basel II and how this will affect HSBC are set out on page 284.

#### UK regulation and supervision

UK banking and financial services institutions are subject to multiple regulations. The primary UK statute is the Financial Services and Markets Act 2000 ("FSMA"). Additionally, data privacy is regulated by the Data Protection Act 1998. Other UK financial services legislation is derived from EU directives relating to banking, securities, insurance, investment and sales of personal financial services.

The FSA is responsible for authorising and supervising UK financial services institutions and regulates all HSBC's businesses in the UK which require authorisation under the FSMA. These include deposit taking, retail banking, life and general insurance, pensions, investments, mortgages, custody and branch share-dealing businesses, and treasury and capital markets activity. HSBC Bank is HSBC's principal authorised institution in the UK.

FSA rules establish the minimum criteria for authorisation for banks and financial services businesses in the UK. They also set out reporting (and, as applicable, consent) requirements with regard to large individual exposures and large exposures to related borrowers. In its capacity as supervisor of HSBC on a consolidated basis, the FSA receives information on the capital adequacy of, and sets requirements for, HSBC as a whole. Further details on capital measurement are included in "Capital management and allocation" on pages 282 to

284. The FSA's approach to capital requirements for UK insurers is to require minimum capital to be calculated on two bases. First, firms must calculate their liabilities on a prudent basis and add a statutory solvency margin (Pillar 1). Secondly, firms must calculate their liabilities on a realistic basis then add to this their own calculation of risk-based capital. The sum of realistic reserves and risk-based capital (Pillar 2) is agreed with the FSA. Insurers are required to maintain capital equal to the higher of Pillars 1 and 2. The FSA has the right to object, on prudential grounds, to persons who hold, or intend to hold, 10 per cent or more of the voting power of a financial institution.

The regulatory framework of the UK financial services system has traditionally been based on co-operation between the FSA and authorised institutions. The FSA monitors authorised institutions through ongoing supervision and the review of routine and *ad hoc* reports relating to financial and prudential matters. The FSA may periodically obtain independent reports, usually from the auditors of the authorised institution, as to the adequacy of internal control procedures and systems as well as procedures and systems governing records and accounting. The FSA meets regularly with HSBC's senior executives to discuss HSBC's adherence to the FSA's prudential guidelines. They also regularly discuss fundamental matters relating to HSBC's business in the UK and internationally, including areas such as strategic and operating plans, risk control, loan portfolio composition and organisational changes, including succession planning.

Consumers of UK financial services institutions are covered by the Financial Services Compensation Scheme ("FSCS"), which is the UK's statutory fund of last resort. It deals with claims against authorised institutions that are unable, or likely to be unable, to pay claims against them, for example if an institution has stopped trading or is in insolvency. FSCS protects deposits, investments, insurance and mortgage advice and arranging, and is funded by levies on institutions authorised by the FSA. The maximum levels of compensation are available on

[www.fscs.org.uk/consumer](http://www.fscs.org.uk/consumer).

**Hong Kong regulation and supervision**

Banking in Hong Kong is subject to the provisions of the Banking Ordinance, and to the powers, functions and duties ascribed by the Banking Ordinance to the Hong Kong Monetary Authority (the [HKMA]). The principal function of the HKMA is to promote the general stability and effective working of the banking system in Hong Kong. The

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HSBC HOLDINGS PLC

## **Report of the Directors: The Management of Risk**

(continued)

### *Regulation and supervision*

HKMA is responsible for supervising compliance with the provisions of the Banking Ordinance. The Banking Ordinance gives power to the Chief Executive of Hong Kong to give directions to the HKMA and the Financial Secretary with respect to the exercise of their respective functions under the Banking Ordinance.

The HKMA has responsibility for authorising banks, and has discretion to attach conditions to its authorisation. The HKMA requires that banks or their holding companies file regular prudential returns, and holds regular discussions with the management of the banks to review their operations. The HKMA may also conduct on-site examinations of banks and, in the case of banks incorporated in Hong Kong, of any local and overseas branches and subsidiaries. The HKMA requires all authorised institutions to have adequate systems of internal control and requires the institutions' external auditors, upon request, to report on those systems and other matters such as the accuracy of information provided to the HKMA. In addition, the HKMA may from time to time conduct tripartite discussions with banks and their external auditors.

The HKMA, which may deny the acquisition of voting power of over 10 per cent in a bank, and may attach conditions to its approval thereof, can effectively control changes in the ownership and control of Hong Kong-incorporated financial institutions. In addition, the HKMA has the power to divest controlling interests in a bank from persons if they are no longer deemed to be fit and proper, if they may otherwise threaten the interests of depositors or potential depositors, or if they have contravened any conditions specified by the HKMA. The HKMA may revoke authorisation in the event of an institution's non-compliance with the provisions of the Banking Ordinance. These provisions require, among other things, the furnishing of accurate reports.

The Banking Ordinance requires that banks submit to the HKMA certain returns and other information and establishes certain minimum standards and ratios relating to capital adequacy (see below), liquidity, capitalisation, limitations on shareholdings, exposure to any one customer, unsecured advances to persons affiliated with the bank and holdings of interests in land, with which banks must comply.

The HKMA implemented Basel II with effect from 1 January 2007 for all Authorised Institutions incorporated in Hong Kong. As under Basel I, each Authorised Institution is required to maintain a capital adequacy ratio (calculated as the ratio of the

bank's capital base to its risk-weighted exposure) of at least 8 per cent. For banks with subsidiaries, the HKMA is empowered to require that the ratio be calculated on a solo and consolidated basis. The HKMA is empowered to increase the minimum capital adequacy ratio (to up to 16 per cent), after consultation with the bank.

Hong Kong depositors are covered by the Deposit Protection Scheme, which covers deposits kept with licensed banks in Hong Kong. All such banks are scheme members unless specifically exempted, and are required to contribute to the funding of the scheme. In the event of the insolvency of a scheme member, each depositor is entitled to receive up to HK\$100,000. Only traditional Hong Kong dollar or foreign currency deposits in Hong Kong are covered by the scheme and other deposit products like structured deposits, secured deposits, bearer instruments and offshore deposits are not protected.

The marketing of, dealing in and provision of advice and asset management services in relation to securities in Hong Kong are subject to the provisions of the Securities and Futures Ordinance of Hong Kong ( Securities and Futures Ordinance ). Entities engaging in activities regulated by the Securities and Futures Ordinance are required to be licensed. The HKMA is the primary regulator for banks involved in the securities business, while the Securities and Futures Commission is the regulator for non-banking entities.

In Hong Kong, insurance business is regulated under the Insurance Companies Ordinance and by the Insurance Authority of Hong Kong. The IAHK is responsible for the licensing of insurers and insurance brokers, although insurance business can also be licensed by the Confederation of Insurance Brokers ( CIB ). Separately, insurance agents are licensed by the Hong Kong Federation of Insurers ( HKFI ). Both the HKFI and the CIB have enacted Codes of Conduct for insurance agents and brokers respectively and can impose sanctions for misbehaviour or breach.

HSBC Insurance (Asia-Pacific) Holdings Limited (["INAH"]) is licensed by the IA as an insurer. The Hongkong and Shanghai Banking Corporation, which is authorised by the HKFI, acts as an agent for INAH, and HSBC Insurance Brokers (Asia-Pacific) Limited acts as insurance brokers licensed by the CIB.

**US regulation and supervision**

HSBC is subject to extensive federal and state supervision and regulation in the US. Banking laws

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and regulations of the Federal Reserve Board, the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC) govern many aspects of HSBC's US business.

HSBC and its US operations are subject to supervision, regulation and examination by the Federal Reserve Board because HSBC is a bank holding company under the US Bank Holding Company Act of 1956 (BHCA). HSBC and HSBC North America Holdings Inc. (HNAH), formed to hold HSBC's US and Canadian operations, are bank holding companies by virtue of their ownership and control of HSBC Bank USA, N.A. (HSBC Bank USA), HSBC National Bank USA (HSBC Bank Maryland), and HSBC Trust Company (Delaware), N.A. (HSBC Bank Delaware). These three banks are nationally chartered FDIC-insured, full-service commercial banks and members of the Federal Reserve System. HSBC also owns HSBC Bank Nevada, N.A. (HSBC Bank Nevada), a nationally chartered bank limited to credit card activities which is also a member of the Federal Reserve System. These four banks are subject to regulation, supervision and examination by the OCC and, as their deposits are insured by the FDIC, they are subject to relevant FDIC regulation. Both HSBC and HNAH are registered as financial holding companies (FHCs) under the BHCA, enabling them to offer a broad range of financial products and services through their subsidiaries. HSBC's and HNAH's ability to engage in expanded financial activities as FHCs depends upon HSBC and HNAH continuing to meet certain criteria set forth in the BHCA, including requirements that their US depository institution subsidiaries, HSBC Bank USA, HSBC Bank Maryland, HSBC Bank Nevada and HSBC Bank Delaware, be well capitalised and well managed, and that such institutions have achieved at least a satisfactory record in meeting community credit needs during their most recent examinations pursuant to the Community Reinvestment Act. These requirements also apply to Wells Fargo HSBC Trade Bank, N.A., in which HSBC and HNAH have a 20 per cent voting interest in equity capital and a 40 per cent economic interest. Each of these depository institutions achieved at least the required rating during their most recent examinations. At 31 December 2007, HSBC Bank USA, HSBC Bank Maryland, HSBC Bank Nevada, HSBC Bank Delaware and Wells Fargo HSBC Trade Bank, N.A. were each well capitalised and well managed under Federal Reserve Board regulations.

In general, under the BHCA, an FHC would be required, upon notice by the Federal Reserve Board,

to enter into an agreement with the Federal Reserve Board to correct any failure to comply with the requirements to maintain FHC status. Until such deficiencies are corrected, the Federal Reserve Board may impose limitations on the US activities of an FHC and depository institutions under its control. If such deficiencies are not corrected, the Federal Reserve Board may require an FHC to divest its control of any subsidiary depository institution or to desist from certain financial activities in the US.

HSBC and HNAH are generally prohibited under the BHCA from acquiring, directly or indirectly, ownership or control of more than 5 per cent of any class of voting shares of, or substantially all the assets of, or exercising control over, any US bank, bank holding company or many other types of depository institutions and/or their holding companies without the prior approval of the Federal Reserve Board and potentially other US banking regulatory agencies.

The Gramm-Leach-Bliley Act of 1999 (GLBA) and the regulations issued thereunder contained a number of other provisions that affect HSBC's operations and the operations of all financial institutions. One such provision contained detailed requirements relating to the financial privacy of consumers. In addition, the so-called "push-out" provisions of GLBA removed the blanket exemption from registration for securities activities conducted in banks (including HSBC Bank USA) under the Exchange Act of 1934, as amended. New rules have been published to implement these changes and, when effective, will allow banks to continue to avoid registration as a broker or dealer only if they conduct securities activities that fall within a set of defined exceptions. A narrowed "dealer" definition took effect in September 2003, and a narrowed "broker" definition will take effect for each bank on the first day of its fiscal year following 30 September 2008. Pursuant to the new regulations, it is likely that certain securities activities currently conducted by HSBC Bank USA will need to be restructured or transferred to one or more US-registered broker-dealer affiliates effective from 1 January 2009.

The US is party to the 1988 Basel I Capital Accord, and US banking regulatory authorities have adopted capital requirements for US banks and bank holding companies that are generally consistent with the Accord.

The authorities have now published, on 7 December 2007, their final Basel II rules for credit and operational risk. These require mandated banking groups, which include HNAH, to have fully



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HSBC HOLDINGS PLC

## **Report of the Directors: The Management of Risk**

(continued)

### *Regulation and supervision / Risk management*

implemented Basel II by no later than 36 months after 1 April 2008, including the completion of a full 12-month parallel run. HSBC is analysing the rules to ensure that systems and processes, already largely developed and implemented, are aligned with the final requirements.

In addition, US banking authorities have adopted [leverage] capital requirements that generally require US banks and bank holding companies to maintain a minimum amount of capital in relation to their balance sheet assets (measured on a non-risk-weighted basis).

The Federal Deposit Insurance Corporation Improvement Act of 1991 provides for extensive regulation of insured depository institutions (such as HSBC Bank USA, HSBC Bank Maryland, HSBC Bank Delaware, HSBC Bank Nevada and Wells Fargo HSBC Trade Bank, N.A.), including requiring federal banking regulators to take [prompt corrective action] with respect to FDIC-insured banks that do not meet minimum capital requirements.

HSBC Bank USA, HSBC Bank Maryland, HSBC Bank Delaware, HSBC Bank Nevada and Wells Fargo HSBC Trade Bank, N.A., like other FDIC-insured banks, may be required to pay assessments to the FDIC for deposit insurance under the FDIC's Bank Insurance Fund. Under the FDIC's risk-based system for setting deposit insurance assessments, an institution's assessments vary according to the level of capital an institution holds, its deposit levels and other factors.

The USA Patriot Act ([Patriot Act]) imposes significant record keeping and customer identity requirements, expands the US federal government's powers to freeze or confiscate assets and increases the available penalties that may be assessed against financial institutions for failure to comply with obligations imposed on such institutions to detect, prevent and report money laundering and terrorist financing. Pursuant to the Patriot Act, final regulations are in effect which impose anti-money laundering compliance obligations on financial institutions (a term which, for this purpose, includes insured US depository institutions, US branches and agencies of foreign banks, US broker-dealers and numerous other entities). Many of the anti-money laundering compliance requirements imposed by the Patriot Act and these implementing regulations are generally consistent with the anti-money laundering compliance obligations existing for banks prior to the Patriot Act. These include requirements to adopt and implement an anti-money laundering programme, report suspicious transactions and implement due diligence procedures for certain

correspondent and private banking accounts. Certain other specific requirements of the Patriot Act were new compliance obligations. The passage of the Patriot Act and other recent events have resulted in heightened scrutiny of the Bank Secrecy Act and anti-money laundering compliance by federal and state bank examiners.

The HSBC Group takes its obligations to prevent money laundering and terrorist financing very seriously. HSBC has policies, procedures and training intended to ensure that its employees know and understand HSBC's criteria for when a client relationship or business should be evaluated as higher risk. As part of its continuing evaluation of risk, the HSBC Group monitors its activities in countries and entities subject to US economic sanctions programmes administered by the Office of Foreign Assets Control. HSBC's business activities include correspondent banking services to banks located in some of these countries and private banking services for nationals of, and clients domiciled in, some of the countries. The Group has a small representative office in Tehran, Iran.

The US State Department has designated certain countries (Cuba, Iran, North Korea, Sudan and Syria) as state sponsors of terrorism, and US law generally prohibits US persons from doing business with such countries. HSBC is aware of initiatives by governmental entities and institutions in the US to adopt rules, regulations or policies



prohibiting transactions with or investments in entities doing business with such countries. The HSBC Group does not believe its business activities with counterparties in, or directly relating to, such countries are material to its business, and such activities represented a very small part of total assets at 31 December 2007 and total revenues for the year ended 31 December 2007.

If HSBC were to fail to maintain and implement adequate programmes to combat money laundering and terrorist financing and to comply with economic sanctions, or was found to be in breach of relevant laws and regulations, including by failing to observe economic sanctions, serious legal and reputational consequences for the Group could arise.

HSBC's US insurance agency and underwriting operations are subject to regulatory supervision under the laws of the states in which they operate. Insurance laws and regulations vary from state to state but generally require forms and rates to be filed with, and approved by, the state insurance departments, and cover licensing of insurance companies; corporate governance; premiums and loss rates; dividend restrictions; types of insurance that may be sold; underwriting processes;

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permissible investments; reserve requirements; and insurance advertising and marketing practices. Each HSBC US insurance subsidiary undergoes periodic market conduct and financial examinations by the relevant state insurance departments, and HSBC's insurance agencies and agents are subject to state licensing and registration requirements.

Additionally, with respect to credit insurance, because it is sold in connection with a loan, state loan laws often contain requirements related to offering, cancelling and refunding credit insurance. Although insurance is not generally regulated by the federal government, certain federal regulations related to lending disclosures apply to the sale and cancellation of credit insurance.

HSBC's US consumer finance operations are subject to extensive state-by-state regulation in the US, and to laws relating to consumer protection (both in general, and in respect of sub-prime lending operations, which have been subject to enhanced regulatory scrutiny); discrimination in extending credit; use of credit reports; privacy matters; disclosure of credit terms; and correction of billing errors. They also are subject to regulations and legislation that limit operations in certain jurisdictions. For example, limitations may be placed on the amount of interest or fees that a loan may bear, the amount that may be borrowed, the types of actions that may be taken to collect or foreclose upon delinquent loans or the information about a customer that may be shared. HSBC's US consumer finance branch lending offices are generally licensed in those jurisdictions in which they operate. Such licences have limited terms but are renewable, and are revocable for cause. Failure to comply with applicable laws and regulations may limit the ability of these licensed lenders to collect or enforce loan agreements made with consumers and may cause the consumer finance lending subsidiary and/or its control person to be liable for damages and penalties.

HSBC's US credit insurance operations are subject to regulatory supervision under the laws of the states in which they operate. Regulations vary from state to state but generally cover licensing of insurance companies; premiums and loss rates; dividend restrictions; types of insurance that may be sold; permissible investments; policy reserve requirements; and insurance marketing practices.

Certain US source payments to foreign persons may be subject to US withholding tax unless the foreign person is a "qualified intermediary". A qualified intermediary is a financial intermediary which is qualified under the US Internal Revenue Code of 1986 and has completed the Qualified

Intermediary Withholding Agreement with the Internal Revenue Service. Various HSBC operations outside the US are qualified intermediaries.

## **Risk management**

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*(Unaudited)*

Introduction

All HSBC's activities involve the measurement, evaluation, acceptance and management of some degree of risk, or combination of risks. The most important risk categories that the Group is exposed to are credit risk (including cross-border country risk), insurance risk, liquidity risk, market risk (including foreign exchange, interest rate and equity price risks), operational risks in various forms, pension risk, residual value risk, reputational risk and sustainability (environmental and social) risks.

The management of these various risk categories is discussed below. Given the distinct characteristics of the insurance business, the management of its credit, liquidity and market risks is described alongside insurance risk in the section "Risk management of insurance operations".

The risk management framework established by the Group seeks to foster the continuous monitoring of the risk environment and an integrated evaluation of risks and their interdependencies.

Risk governance and ownership

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A well-established risk governance and ownership structure ensures oversight of, and accountability for, the effective management of risk at Group, regional, customer group and operating entity levels.

The Board of Directors of HSBC Holdings approves plans and performance targets for the Group and its principal subsidiaries, the appointment of senior officers, the delegation of authorities for credit and other risks and the establishment of effective control procedures. Under authority delegated by the Board of Directors, Group Management Board (GMB) formulates high-level Group risk management policy.

A separately convened Risk Management Meeting (RMM) of GMB has the responsibility for exercising and delegating risk approval authorities, setting risk appetite and approving definitive risk policies and controls. It monitors all categories of risk, receives reports, determines action to be taken and reviews the efficacy of HSBC's risk management framework.

GMB and RMM are supported by a dedicated Group Risk function headed by the Group Chief Risk

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HSBC HOLDINGS PLC

**Report of the Directors: The Management of Risk**

(continued)

*Credit risk > Credit risk management*

Officer (GCRO), who is a member of both GMB and RMM and reports to the Group Finance Director within an integrated Finance and Risk function. Similar structures involving the creation of local Chief Risk Officers are being extended to all major Group subsidiaries and customer groups during 2008. The Group Finance Director represents Finance and Risk on the HSBC Holdings Board.

Primary responsibility for managing risk at operating entity level lies with the respective boards and Chief Executive Officers, as custodians of the relevant balance sheets. In turn, Group Risk has functional responsibility for the principal financial risk types, namely: retail and wholesale credit, market, operational and security/fraud risks. Within this structure, it establishes Group policy, exercises Group-wide oversight and provides reporting and analysis of portfolio composition on a global and a regional basis to senior management. Group Risk co-ordinates the further development of the risk appetite, economic capital and stress-testing frameworks. In addition, the GCRO is a member of the Group Portfolio Oversight Committee, chaired by the Group Treasurer, which governs the Group's portfolio management activities for the wholesale business sector.

HSBC's risk management policies, encapsulated in the Group Standards Manual and cascaded in a hierarchy of policy manuals throughout the Group, are designed to support the formulation of risk appetite, guide employees and establish procedures for monitoring and controlling risks, with timely and reliable reporting to management. HSBC regularly reviews and updates its risk management policies and systems to reflect changes in markets, products and emerging best practice.

It is the responsibility of all Group officers to identify, assess and manage risk within the scope of their assigned responsibilities. Personal accountability, reinforced by the Group's governance structure and instilled by training, helps to foster throughout the Group a disciplined and constructive culture of risk management and control.

**Credit risk****Credit risk management***(Audited)*

Credit risk is the risk of financial loss if a customer or counterparty fails to meet an obligation under a contract. It arises principally from direct lending, trade finance and leasing business, but also from certain off-balance sheet products such as guarantees and credit derivatives, and from the Group's holdings of assets in the form of debt securities.

HSBC has standards, policies and procedures dedicated to monitoring and managing risk from such activities.

Within Head Office, the Group Risk function provides high-level centralised oversight and management of credit risk for HSBC worldwide. Its responsibilities include:

- Formulating Group credit policy. Compliance, subject to approved dispensations, is mandatory for all HSBC's operating companies, which must formulate and record in local instruction manuals their detailed credit policies and procedures, consistent with Group policy.
- Guiding HSBC's operating companies on the Group's appetite for, and attitude to, credit risk exposure to specified market sectors, activities and banking products. Group Risk controls exposures to certain higher-risk sectors and closely monitors exposure to others, including: real estate, the automotive sector,

certain non- bank financial institutions, structured products and leveraged finance transactions. When necessary, restrictions are imposed on new business or exposures, which may be capped at Group and/or entity level.

- Undertaking independent review and objective assessment of risk. Group Risk assesses all commercial non-bank credit facilities and exposures – including those embedded in derivatives – that are originated or renewed by HSBC’s operating companies over designated limits, prior to the facilities being committed to customers or transactions being undertaken. Operating companies may not confirm credit approval without this concurrence.
- Monitoring the performance and management of retail portfolios across the Group. Group Risk tracks emerging trends, overseeing the effective management of any adverse characteristics.
- Controlling centrally exposures to sovereign entities, banks and other financial institutions. HSBC’s credit and settlement risk limits to counterparties in these sectors are approved and managed by Group Risk to optimise the use of credit availability and avoid excessive risk concentration.
- Establishing and managing exposures to debt securities by establishing controls in respect of securities held for trading purposes and setting issuer limits for securities not held for trading.
- Establishing and maintaining HSBC’s policy on large credit exposures, ensuring that

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concentrations of exposure by counterparty, sector or geography do not become excessive in relation to the Group's capital base and remain within internal and regulatory limits. The approach is designed to be more conservative than internationally accepted regulatory standards. Group Risk also monitors HSBC's intra-Group exposures to ensure they are maintained within regulatory limits. Plans are well developed to adopt the FSA's new "Integrated Groups" regime in accordance with the agreed transition timetable.

- Controlling cross-border exposures, through the imposition of country limits with sub-limits by maturity and type of business. Country limits are determined by taking into account economic and political factors, and applying local business knowledge. Transactions with countries deemed to be higher risk are considered on a case by case basis.
- Maintaining and developing HSBC's risk rating framework and systems, to classify exposures meaningfully and enable focused management of the risks involved. The GCRO chairs the Credit Risk Analytics Oversight Committee, which reports to the RMM and oversees risk rating model governance for both wholesale and retail business. Rating methodologies are based upon a wide range of analytics and market data- based tools, which are core inputs to the assessment of customer risk. For larger facilities, while full use is made of automated risk rating processes, the ultimate responsibility for setting risk ratings rests with the final approving executive. Details of HSBC's approach under Basel II to capital management and allocation in relation to risk may be found on page 284.
- Reporting on aspects of the HSBC credit risk portfolio to the RMM, the Group Audit Committee and the Board of Directors of HSBC Holdings by way of a variety of regular and ad hoc reports covering:
  - risk concentrations;
  - retail portfolio performance at Group entity, regional and overall Group levels;
  - specific higher-risk portfolio segments;
  - individual large impaired accounts, and impairment allowances/charges for all customer segments;
  - country limits, cross-border exposures and related impairment allowances;
  - portfolio and analytical model performance data; and
  - stress-testing results and recommendations.
- Managing and directing credit risk management systems initiatives. HSBC has constructed a centralised database covering substantially all the Group's direct lending exposures, to deliver an increasingly granular level of management reporting. An electronic credit application process for banks is operational throughout the Group and a similar corporate credit application system covers almost all Group corporate business by value.
- Providing advice and guidance to HSBC's operating companies, to promote best practice throughout the Group on credit-related matters such as sustainability risk, new products and training.
- Acting on behalf of HSBC Holdings as the primary interface, for credit-related issues, with external parties including the Bank of England, the FSA, rating agencies, corporate analysts, trade associations and counterparts in the world's major banks and non-bank financial institutions.

Each HSBC operating company is required to implement credit policies, procedures and lending guidelines that conform to Group standards, with credit approval authorities delegated from the Board of Directors of HSBC Holdings to the relevant Chief Executive Officer. In each major subsidiary, a Chief Risk Officer or Chief Credit Officer reports to the local Chief Executive Officer or Chief Operating Officer on credit-related issues, maintaining a strong functional reporting line to the GCRO.

Each operating company is responsible for the quality and performance of its credit portfolios and for monitoring and controlling all credit risks in its portfolios, including those subject to central approval by Group

Risk. This includes managing its own risk concentrations by market sector, geography and product. Local systems are in place throughout the Group to enable operating companies to control and monitor exposures by customer and retail product segments.

Special attention is paid to problem exposures, which are subject to more frequent and intensive review and reporting, in order to accelerate remedialaction. Where appropriate, HSBC's local operating companies maintain or establish specialist units to provide customers with support in order to help them avoid default wherever possible.

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HSBC HOLDINGS PLC

## **Report of the Directors: The Management of Risk** (continued)

*Credit risk > Credit risk management*

Periodic risk-based audits of operating companies' credit processes and portfolios are undertaken by HSBC's Internal Audit function. Audits include consideration of the adequacy and clarity of credit policy/procedure manuals; an in-depth analysis of a representative sample of accounts; an overview of homogeneous portfolios of similar assets to assess the quality of the loan book and other exposures; consideration of any oversight or review work performed by credit risk management functions and the adequacy of impairment calculations; a review of analytical model governance and implementation; a review of management objectives and a check that Group and local standards and policies are adhered to in the approval and management of credit facilities.

Individually significant accounts are reviewed on a sample basis to ensure that risk ratings are appropriate, that credit and collection procedures have been properly followed and that, when an account or portfolio evidences deterioration, impairment allowances are raised in accordance with the Group's established processes. Internal Audit discusses with management risk ratings it considers to be inappropriate; after discussion, its final recommendations for revised ratings must then be adopted.

Collateral and other credit enhancements  
(Audited)

### **Loans and advances**

It is HSBC's policy, when lending, to do so within the customer's capacity to repay, rather than rely excessively on security. Depending on the customer's standing and the type of product, facilities may be unsecured. Nevertheless, collateral can be an important mitigant of credit risk.

Operating companies are required to implement appropriate guidelines on the acceptability of specific classes of collateral or credit risk mitigation, and determine suitable valuation parameters. Such parameters, structures and legal covenants are required to be subject to regular review to ensure that they are supported by empirical evidence and continue to fulfil their intended purpose. The principal collateral types are as follows:

- in the personal sector, mortgages over residential properties;
- in the commercial and industrial sector, charges over business assets such as premises, stock and debtors;
- in the commercial real estate sector, charges over the properties being financed; and
- in the financial sector, charges over financial instruments such as debt securities and equities in support of trading facilities.

In addition, credit derivatives, including credit default swaps and structured credit notes, as well as securitisation structures, are used to manage credit risk in the Group's loan portfolio.

HSBC does not disclose the fair value of collateral held as security or other credit enhancements on loans and advances past due but not impaired, or on individually assessed impaired loans and advances, as it is not practicable to do so.

### **Other financial assets**

Collateral held as security for financial assets other than loans and advances is determined by the nature of the instrument. Debt securities, treasury and other eligible bills are generally unsecured, with the exception of asset-backed securities and similar instruments, which are secured by pools of financial assets.



The ISDA Master Agreement is HSBC's preferred agreement for documenting derivatives activity. It provides the contractual framework within which dealing activity across a full range of over-the-counter products is conducted, and contractually binds both parties to apply close-out netting across all outstanding transactions covered by an agreement if either party defaults or other pre-agreed termination events occur. It is common, and HSBC's preferred, practice for the parties to execute a Credit Support Annex (CSA) in conjunction with the ISDA Master Agreement. Under a CSA, collateral is passed between the parties to mitigate the market-contingent counterparty risk inherent in the outstanding positions.

Settlement risk arises in any situation where a payment in cash, securities or equities is made in the expectation of a corresponding receipt in cash, securities or equities. Daily settlement limits are established for each counterparty to cover the aggregate of all settlement risk arising from HSBC's transactions with them, on any single day. Settlement risk on many transactions, particularly those involving securities and equities, is substantially mitigated through being effected via assured payment systems, or on a delivery-versus-payment basis.

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#### Credit quality of loans and advances (Audited)

HSBC's credit risk rating systems and processes differentiate exposures in order to highlight those with greater risk factors and higher potential severity of loss. For individually significant accounts, risk ratings are reviewed regularly and amendments, where necessary, are implemented promptly. Within the Group's retail portfolios, risk is assessed and managed using a wide range of risk and pricing models.

For many years, HSBC has deployed a seven-grade rating system based on a "composite" assessment of the likelihood and extent of delinquency and risk mitigation (for details, see page 224).

This legacy risk rating scale is being superseded by a more sophisticated and granular methodology, based on probability of default and loss estimates, compliant with an internal ratings-based ("IRB") approach required to support the Basel II framework for calculating the Group's minimum capital requirement. The integration of this framework into reporting structures will enable Board and regulatory reporting on the new basis in accordance with the Group's IRB obligations. The new framework is well embedded in the Group's principal operating entities.

#### Impairment assessment (Audited)

When impairment losses occur, HSBC reduces the carrying amount of loans and advances and held-to-maturity financial investments through the use of an allowance account. When impairment of available-for-sale financial assets occurs, the carrying amount of the asset is reduced directly.

Two types of impairment allowance are in place: individually assessed and collectively assessed, as discussed below.

Impairment allowances may be assessed and created either for individually significant accounts or, on a collective basis, for groups of individually significant accounts for which no evidence of impairment has been individually identified or for high-volume groups of homogeneous loans that are not considered individually significant.

It is HSBC's policy that each operating company creates allowances for impaired loans promptly and on a consistent basis.

Management regularly evaluates the adequacy of the established allowances for impaired loans by conducting a detailed review of the loan portfolio,

comparing performance and delinquency statistics with historical trends and assessing the impact of current economic conditions.

#### **Individually assessed impairment allowances**

These are determined by evaluating exposure to loss, case by case, on all individually significant accounts and all other accounts that do not qualify for the collective assessment approach outlined below. Loans are treated as impaired as soon as there is objective evidence that an impairment loss has been incurred. The criteria used by HSBC to determine that there is such objective evidence include, *inter alia* :

- known cash flow difficulties experienced by the borrower;
- past due contractual payments of either principal or interest;
- breach of loan covenants or conditions;
- the probability that the borrower will enter bankruptcy or other financial realisation; and

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- a significant downgrading in credit rating by an external credit rating agency. In determining the level of allowances on such accounts, the following factors are typically considered:
- HSBC's aggregate exposure to the customer;
- the viability of the customer's business model and their capacity to trade successfully out of financial difficulties, generating sufficient cash flow to service debt obligations;
- the ability of the borrower to obtain, and make payments in, the currency of the loan if not denominated in local currency;
- the amount and timing of expected receipts and recoveries;
- the extent of other creditors' commitments ranking ahead of, or *pari passu* with, HSBC and the likelihood of other creditors continuing to support the company;
- the complexity of determining the aggregate amount and ranking of all creditor claims and the extent to which legal and insurance uncertainties are evident;
- the value of security and likelihood of successfully realising it;
- the existence of other credit mitigants and the ability of the providers of such credit mitigants to deliver as contractually committed; and

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HSBC HOLDINGS PLC

## Report of the Directors: The Management of Risk (continued)

*Credit risk > Credit risk management / Exposure*

- when available, the secondary market price of the debt.

The level of impairment allowances on individually significant accounts that are above defined materiality thresholds is reviewed at least semi-annually, and more regularly when circumstances require. This normally encompasses re-assessment of the enforceability of any collateral held and of actual and anticipated receipts. For significant commercial and corporate debts, specialised loan [work-out] teams with experience in insolvency and specific market sectors are used to manage the lending and assess likely losses.

Individually assessed impairment allowances are only released when there is reasonable and objective evidence of a reduction in the established loss estimate.

### Collectively assessed impairment allowances

Impairment is assessed on a collective basis in two circumstances:

- to cover losses that have been incurred but have not yet been identified on loans subject to individual assessment; and
- for homogeneous groups of loans that are not considered individually significant.

*Incurred but not yet identified impairment*

Individually assessed loans for which no evidence of impairment has been specifically identified on an individual basis are grouped together according to their credit risk characteristics. A collective impairment allowance is calculated to reflect impairment losses incurred at the balance sheet date which will only be individually identified in the future.

The collective impairment allowance is determined having taken into account:

- historical loss experience in portfolios of similar credit risk characteristics (for example, by industry sector, risk rating or product segment);
- the estimated period between impairment occurring and the loss being identified and evidenced by the establishment of an appropriate allowance against the individual loan; and
- management's experienced judgement as to whether current economic and credit conditions are such that the actual level of inherent losses is likely to be greater or less than that suggested by historical experience.

The period between a loss occurring and its identification is estimated by local management for each identified portfolio. In general, the periods used vary between four and twelve months although, in exceptional cases, longer periods are warranted.

The basis on which impairment allowances for incurred but not yet identified losses is established in each reporting entity is documented and reviewed by senior Finance and Credit Risk management to ensure conformity with Group policy.

*Homogeneous groups of loans*

Two methodologies are used to calculate impairment allowances where large numbers of relatively low-value assets are managed using a portfolio approach, typically:

- low-value, homogeneous small business accounts in certain countries or territories;
- residential mortgages that have not been individually assessed;
- credit cards and other unsecured consumer lending products; and
- motor vehicle financing.

When appropriate empirical information is available, the Group uses roll rate methodology. This employs a statistical analysis of historical trends of default and the amount of consequential loss, based on the delinquency of accounts within a portfolio of homogeneous accounts. Other historical data and current economic conditions are also evaluated when calculating the appropriate level of impairment allowance required to cover inherent loss. In certain highly developed markets, models also take into account behavioural and account management trends revealed in, for example, bankruptcy and rescheduling statistics.

When the portfolio size is small, or when information is insufficient or not reliable enough to adopt a roll rate methodology, a formulaic approach is used that allocates progressively higher percentage loss rates the longer a customer's loan is overdue. Loss rates reflect the discounted expected future cash flows for a portfolio.

Generally, historical experience is the most objective and relevant information from which to begin to assess inherent loss within each portfolio. In circumstances where historical loss experience provides less relevant information about the inherent loss in a given portfolio at the balance sheet date – for example, where there have been changes in economic conditions or regulations – management considers the more recent trends in the portfolio risk

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factors which may not be adequately reflected in its statistical models and, subject to guidance from Group Finance and Group Risk, adjusts impairment allowances accordingly.

Roll rates, loss rates and the expected timing of future recoveries are regularly benchmarked against actual outcomes to ensure they remain appropriate.

### **Write-off of loans and advances**

Loans are normally written off, either partially or in full, when there is no realistic prospect of further recovery. Where loans are secured, this is generally after receipt of any proceeds from the realisation of security.

In the case of residential mortgages and second lien loans in HSBC Finance, loan carrying amounts in excess of net realisable value are written off at or before the time foreclosure is completed or when settlement is reached with the borrower. If foreclosure is not pursued, and there is no reasonable expectation of recovery, the loan is normally written off no later than the end of the month in which the loan becomes 240 days contractually past due.

Unsecured personal facilities, including credit cards, are generally written off at between 150 and 210 days past due, the standard period being the end of the month in which the account becomes 180 days contractually delinquent. This period may be extended, generally to 300 days past due but in no event exceeding 360 days past due, in the case of a small proportion of HSBC Finance's cards business and unsecured personal facilities other than credit cards.

Cases of write-off periods exceeding 360 days past due are few but arise, for example, in a few countries where local regulation or legislation constrain earlier write-off, or where the realisation of collateral for secured real estate lending takes place at this time.

In the event of bankruptcy or analogous proceedings, write-off can occur earlier than at the periods stated above. Collections procedures may continue after write-off.

### **Cross-border exposures**

Management assesses the vulnerability of countries to foreign currency payment restrictions when considering impairment allowances on cross-border exposures. This assessment includes an analysis of the economic and political factors existing at the time. Economic factors include the level of external indebtedness, the debt service burden and access to external sources of funds to meet the debtor

country's financing requirements. Political factors taken into account include the stability of the country and its government, threats to security, and the quality and independence of the legal system.

Impairment allowances are assessed in respect of all qualifying exposures within these countries unless these exposures and the inherent risks are:

- performing, trade-related and of less than one year's maturity;
- mitigated by acceptable security cover which is, other than in exceptional cases, held outside the country concerned;
- in the form of securities held for trading purposes for which a liquid and active market exists, and which are measured at fair value daily;
- performing facilities with principal (excluding security) of US\$1 million or below; or
- performing facilities with maturity dates shorter than three months.

Credit exposure

Maximum exposure to credit risk  
(Audited)

HSBC's exposure to credit risk is spread over several asset classes, including trading assets, loans to customers, loans to banks and financial investments. Recently, loss experience has mainly affected personal lending portfolios. Thus, in 2007, 94 per cent of loan impairment charges arose in Personal Financial Services, broadly in line with 2006.

The deterioration of credit conditions in the US mortgage market was the most significant factor affecting HSBC's exposure to credit risk during 2007. A full discussion of this issue can be found in the commentary on Areas of Special Interest on page 216.

The following table presents the maximum exposure to credit risk of balance sheet and off-balance sheet financial instruments, before taking account of any collateral held or other credit enhancements unless such credit enhancements meet offsetting requirements as set out in Note 2m on the Financial Statements. For financial assets recognised on the balance sheet, the exposure to credit risk equals their carrying amount. For financial guarantees granted, the maximum exposure to credit risk is the maximum amount that HSBC would have to pay if the guarantees were called upon. For loan commitments and other credit-related commitments that are irrevocable over the life of the respective

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HSBC HOLDINGS PLC

**Report of the Directors: The Management of Risk** (continued)*Credit risk > Exposure*

facilities, the maximum exposure to credit risk is the full amount of the committed facilities.

Note 18 on the Financial Statements gives more information on credit risk exposure to derivatives counterparties.

**Maximum exposure to credit risk**  
(Audited)

	Maximum exposure	
	2007 US\$m	2006 US\$m
Items in course of collection from other banks	9,777	14,144
Trading assets	394,492	300,998
Treasury and other eligible bills	16,439	21,759
Debt securities	178,834	155,447
Loans and advances	199,219	123,792
Financial assets designated at fair value	21,517	9,971
Treasury and other eligible bills	181	133
Debt securities	21,150	9,449
Loans and advances	186	389
Derivatives	187,854	103,702
Loans and advances held at amortised cost	1,218,914	1,053,338
Loans and advances to banks	237,366	185,205
Loans and advances to customers	981,548	868,133
Financial investments	270,406	196,509
Treasury and other eligible bills	30,104	25,313
Debt securities	240,302	171,196
Other assets	25,291	22,846
Endorsements and acceptances	12,248	9,577
Other	13,043	13,269
Financial guarantees	56,440	62,014



Loan commitments and other credit-related commitments <sup>1</sup>	<b>764,457</b>	714,630
At 31 December	<b>2,949,148</b>	2,478,152

<sup>1</sup> *The amount of the loan commitments reflects, where relevant, the expected level of take-up of pre-approved loan offers made by mailshots to personal customers. In addition to those amounts, there is a further maximum possible exposure to credit risk of US\$317,834 million (2006: US\$464,984 million), reflecting the full take-up of such irrevocable loan commitments. The take-up of such offers is generally at modest levels.*

#### Concentration of exposure

*(Audited)*

Concentrations of credit risk exist when a number of counterparties are engaged in similar activities, or operate in the same geographical areas or industry sectors and have comparable economic characteristics, so that their ability to meet contractual obligations is uniformly affected by changes in economic, political or other conditions.

#### **Loans and advances**

*(Unaudited)*

Loans and advances were well diversified across industry sectors and jurisdictions.

At constant exchange rates, gross loans and advances to customers (excluding the financial sector and settlement accounts) grew by US\$55 billion or 7 per cent during 2007. On the

same basis, personal lending comprised 56 per cent of HSBC's loan portfolio and 23 per cent of the growth in loans in 2007.

Including the financial sector and settlement accounts, personal lending represented US\$501 billion, or 50 per cent, of total loans and advances to customers at 31 December 2007. Within this total, residential mortgages were US\$269 billion and, at 27 per cent of total advances to customers, comprised the Group's largest single sectoral concentration.

Corporate, commercial and financial lending, including settlement accounts, amounted to 50 per cent of gross lending to customers at 31 December 2007. The largest industry concentrations were in non-bank financial institutions and commercial real estate lending at 10 per cent and 7 per cent, respectively, of total gross lending to customers.

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Lending to non-bank financial institutions principally comprises secured lending on trading accounts, primarily repo facilities.

Commercial, industrial and international trade lending grew strongly in 2007, rising by a percentage point to 20 per cent of total gross loans and advances to customers. Within this category, the largest concentration of lending was to the service sector, which amounted to 6 per cent of total gross lending to customers.

Advances to banks primarily represent amounts owing on trading account and HSBC's placing of its own liquidity on short-term deposit. Such lending was widely distributed across major institutions, with no single exposure exceeding 5 per cent of total advances to banks.

### **Financial investments**

*(Unaudited)*

At US\$270 billion, total financial investments, excluding equity securities, were 38 per cent higher at 31 December 2007 than at the end of 2006. Debt securities, at US\$240 billion, represented the largest concentration of financial investments at 89 per cent of the total, compared with US\$171 billion (87 per cent) at 31 December 2006. HSBC's holdings of corporate debt, asset-backed securities and other securities were spread across a wide range of issuers and geographical regions, with 50 per cent invested in securities issued by banks and other financial institutions. The principal movement in financial investments in 2007 represented the consolidation of HSBC-sponsored SIVs together with certain debt securities purchased from the Group's money market funds as noted on page 186

Investments in governments and government agencies of US\$92 billion were 33 per cent of overall financial investments, 5 percentage points lower than in 2006. US\$30 billion of these investments comprised treasury and other eligible bills.

A more detailed analysis of financial investments is set out in Note 19 on the Financial Statements and an analysis by Rating Agency designation is provided on page 215.

The insurance businesses held diversified portfolios of debt and equity securities designated at fair value (2007: US\$34 billion; 2006: US\$18 billion) and debt securities classified as financial investments (2007: US\$23 billion; 2006: US\$10 billion). The increase was due to the acquisition of HSBC's partner's share in HSBC Assurances.

A more detailed analysis of securities held by the insurance businesses is set out on page 276.

### **Securities held for trading**

*(Unaudited)*

Total securities held for trading within trading assets were US\$247 billion at 31 December 2007 (2006: US\$204 billion). The largest concentration of these assets was government and government agency securities, which amounted to US\$115 billion, or 46 per cent of overall trading securities (2006: US\$94 billion, 46 per cent). This included US\$16 billion (2006: US\$22 billion) of treasury and other eligible bills. Corporate debt and other securities were US\$60 billion or 24 per cent of overall trading securities, 9 percentage points lower than 2006's level of 33 per cent at US\$67 billion. Included within total securities held for trading were US\$70 billion (2006: US\$36 billion) of debt securities issued by banks and other financial institutions.

A more detailed analysis of securities held for trading is set out in Note 16 on the Financial Statements and an analysis by Rating Agency designation is provided on page 215.

### **Financial assets – net exposure to credit risk**

*(Audited)*

In respect of certain financial assets, HSBC has legally enforceable rights to offset them with financial liabilities. In normal circumstances, however, there would be no intention of settling net, or of realising the financial assets and settling the financial liabilities simultaneously. Consequently, the financial assets are not offset against the respective financial liabilities for financial reporting purposes. However, the exposure to credit risk relating to the respective financial assets is mitigated as follows:

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HSBC HOLDINGS PLC

**Report of the Directors: The Management of Risk** (continued)*Credit risk > Exposure > 2007***Financial assets □ net exposure to credit risk***(Audited)*

	At 31 December 2007			At 31 December 2006		
	Carrying amount US\$m	Offset US\$m	Net exposure to credit risk <sup>1</sup> US\$m	Carrying amount US\$m	Offset US\$m	Net exposure to credit risk <sup>1</sup> US\$m
Trading assets	<b>394,492</b>	<b>(12,220)</b>	<b>382,272</b>	300,998	(8,238)	292,760
Treasury and other eligible bills	<b>16,439</b>	□	<b>16,439</b>	21,759	(16)	21,743
Debt securities	<b>178,834</b>	<b>(1,417)</b>	<b>177,417</b>	155,447	(1,036)	154,411
Loans and advances to banks	<b>100,440</b>	<b>(994)</b>	<b>99,446</b>	52,006	□	52,006
Loans and advances to customers	<b>98,779</b>	<b>(9,809)</b>	<b>88,970</b>	71,786	(7,186)	64,600
Financial assets designated at fair value	<b>21,517</b>	□	<b>21,517</b>	9,971	□	9,971
Treasury and other eligible bills	<b>181</b>	□	<b>181</b>	133	□	133
Debt securities	<b>21,150</b>	□	<b>21,150</b>	9,449	□	9,449
Loans and advances to banks	<b>178</b>	□	<b>178</b>	236	□	236
Loans and advances to customers	<b>8</b>	□	<b>8</b>	153	□	153
Derivatives	<b>187,854</b>	<b>(121,709)</b>	<b>66,145</b>	103,702	(62,741)	40,961
Loans and advances held at amortised cost	<b>1,218,914</b>	<b>(66,983)</b>	<b>1,151,931</b>	1,053,338	(68,531)	984,807
Loans and advances to banks	<b>237,366</b>	<b>(278)</b>	<b>237,088</b>	185,205	(455)	184,750
Loans and advances to customers	<b>981,548</b>	<b>(66,705)</b>	<b>914,843</b>	868,133	(68,076)	800,057
Financial investments	<b>270,406</b>	□	<b>270,406</b>	196,509	(31)	196,478
Treasury and other similar bills	<b>30,104</b>	□	<b>30,104</b>	25,313	(30)	25,283
Debt securities	<b>240,302</b>	□	<b>240,302</b>	171,196	(1)	171,195
Other assets	<b>12,248</b>	<b>(226)</b>	<b>12,022</b>	9,577	(187)	9,390

Endorsements and  
acceptances

<b>2,105,431</b>	<b>(201,138)</b>	<b>1,904,293</b>	1,674,095	(139,728)	1,534,367
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1 Excluding the value of any collateral held or other credit enhancements.

**Gross loans and advances by industry sector**

(Unaudited)

	At 31 December 2006 US\$m	Constant currency effect US\$m	Movement on a constant currency basis US\$m	At 31 December 2007 US\$m
<b>Loans and advances to customers</b>				
Personal	476,146	11,991	12,697	<b>500,834</b>
Residential mortgages <sup>1</sup>	265,337	6,472	(2,741)	<b>269,068</b>
Other personal <sup>2</sup>	210,809	5,519	15,438	<b>231,766</b>
Corporate and commercial	343,107	15,088	42,576	<b>400,771</b>
Commercial, industrial and international trade	162,109	7,009	32,920	<b>202,038</b>
Commercial real estate	60,366	2,966	9,013	<b>72,345</b>
Other property-related	27,165	1,321	5,421	<b>33,907</b>
Government	8,990	128	(3,410)	<b>5,708</b>
Other commercial <sup>3</sup>	84,477	3,664	(1,368)	<b>86,773</b>
Financial	62,458	2,406	34,284	<b>99,148</b>
Non-bank financial institutions	59,204	2,310	35,267	<b>96,781</b>
Settlement accounts	3,254	96	(983)	<b>2,367</b>
<b>Total loans and advances to customers</b>	<b>881,711</b>	<b>29,485</b>	<b>89,557</b>	<b>1,000,753</b>
<b>Loans and advances to banks</b>	<b>185,212</b>	<b>8,064</b>	<b>44,097</b>	<b>237,373</b>
<b>Total gross loans and advances</b>	<b>1,066,923</b>	<b>37,549</b>	<b>133,654</b>	<b>1,238,126</b>

1 Including Hong Kong Government Home Ownership Scheme loans of US\$3,942 milli on at 31 December 2007.

2 Other personal loans and advances include second lien mortgages and other property-related lending.

3 Other commercial loans and advances include advances in respect of agriculture, transport, energy and utilities.

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Year ended 31 December 2007 compared with year ended 31 December 2006  
(Unaudited)

The following commentary analyses, on a constant currency basis, the changes in lending noted in the table above compared with the position at 31 December 2006. Loans and advances to personal, corporate and commercial customers rose by 7 per cent, and total gross loans and advances grew by 12 per cent. There was a marked change in the distribution of net new lending in 2007 with personal lending growing significantly slower than corporate and commercial lending, primarily as a consequence of curtailing loan growth in US consumer finance.

Total lending to personal customers remained predominantly in North America (2007: US\$231 billion; 2006: US\$232 billion), the UK (2007: US\$128 billion; 2006: US\$131 billion) and Hong Kong (2007: US\$43 billion; 2006: US\$39 billion). These three regions comprised 80 per cent of total personal lending, a decline of 3 percentage points since 31 December 2006.

**Residential mortgages** fell marginally to US\$269 billion at 31 December 2007, 27 per cent (2006: 30 per cent) of total loans and advances to customers (including the finance sector and settlement accounts). A reduction in the US mortgage loan portfolio was partly offset by increases in Europe, Hong Kong, Rest of Asia-Pacific and Latin America.

In Europe, residential mortgage balances rose by 1 per cent to US\$96 billion. In France, mortgage lending grew by 11 per cent to US\$6 billion, despite increasing competition, due to strong customer demand. In Turkey, strong growth of 13 per cent was driven by the expansion of the branch network. Mortgage lending in the UK was flat, with risk appetite restricted as margins on mortgage lending fell. There was also a shift in the portfolio towards fixed-rate mortgages.

In Hong Kong, residential mortgage balances rose by 3 per cent as a result of a buoyant economy.

In North America, residential mortgage balances decreased by 6 per cent. In the US, the level of mortgage lending stood at US\$99 billion, a decline of 8 per cent since 31 December 2006. Balances in the mortgage services business fell by 27 per cent as the strategy to run down the book of business originated through correspondents was put into effect. The rundown was carried out through repayments in the normal course of business, as well as the sale of loans to third party investors and the cessation of all remaining origination following the closure of the wholesale activities of Decision One.

The write-off of impaired loans also contributed to the decline in residential mortgage balances. Balances elsewhere in the consumer lending business increased by 9 per cent. In the fourth quarter of 2007, management took a further series of actions to limit originations in the branch-based consumer lending business in respect of mortgage lending, which resulted in fewer new loans in the quarter and will markedly limit growth in this area for the foreseeable future. In Canada, mortgage balances rose by 7 per cent, driven by the buoyant Canadian residential property market and continued expansion of the branch network.

Mortgage lending balances rose by 10 per cent in Rest of Asia-Pacific, with increases in the Middle East and Singapore partly offset by the sale of the New Zealand mortgage loan portfolio in July 2007.

In Latin America, balances increased by 18 per cent, driven by rises of 23 per cent and 31 per cent in Mexico and Brazil, respectively.

**Other personal lending** increased by 7 per cent to US\$232 billion at 31 December 2007, representing 23 per cent of total loans and advances to customers, including the financial sector and settlement accounts (2006: 24 per cent).

In Europe, other personal lending rose by 4 per cent to US\$73 billion. Strong growth in lending to Private Banking clients in Switzerland, (rising by 50 per cent), a 42 per cent rise in Turkey and a 7 per cent rise in France were partly offset by a 7 per cent decline in the UK as HSBC curtailed growth through tightened

underwriting criteria. Also in the UK, HSBC disposed of part of its non-core credit card portfolio, principally the Marbles brand, at the end of 2007.

In Hong Kong, other personal lending rose by 29 per cent to US\$13 billion as HSBC launched a series of credit card campaigns that consolidated the Group's position as market leader. Other unsecured lending rose by 46 per cent.

In Rest of Asia-Pacific, other personal lending increased by 19 per cent as branch expansion and enhanced marketing activity led to higher loan balances. Credit cards in circulation rose, with the Middle East and India, in particular, producing strong increases.

In North America, other personal lending balances rose by 2 per cent. In the US, asset levels remained broadly unchanged despite a significant decline in second lien mortgage balances. Unsecured personal lending in HSBC Finance fell, offset by a rise at HSBC's US retail bank and strong growth in card balances from the momentum created by

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HSBC HOLDINGS PLC

## Report of the Directors: The Management of Risk (continued)

Credit risk > Exposure > 2007 / By industry sector

marketing initiatives in late 2006. In Canada, other personal lending balances rose by 23 per cent, with strong growth in both the consumer finance and retail bank lending portfolios.

In Latin America, other personal lending balances rose by 34 per cent to US\$17 billion, due to growth in credit cards and payroll loans. In Mexico, where marketing campaigns added customers and portfolio management programmes were put in place to improve customer retention and card usage, the strong growth in credit card balances drove a 41 per cent rise in lending. In Brazil, other personal lending balances increased by 28 per cent.

**Loans and advances to corporate and commercial customers** increased by 12 per cent to US\$401 billion (2006: US\$358 billion), with strong growth in most regions.

In Europe, corporate and commercial advances rose by 10 per cent. In the UK, asset balances rose by 8 per cent as investment in direct sales channels and the recruitment of sales staff led to increased customer numbers. In France, lending balances increased by 12 per cent as HSBC continued to raise its brand profile.

In Hong Kong, HSBC achieved growth in corporate commercial lending of 3 per cent, due to increased demand for loans from manufacturers with operations in mainland China, and for other intra-Asian trading.

In Rest of Asia-Pacific, the corporate and commercial loan book increased by 29 per cent as expanded operations helped to gain new business. Strong growth was recorded in many countries, including South Korea (42 per cent), India (34 per cent) and mainland China (83 per cent). HSBC set up new International Banking Centres, increased its branch network and launched enhanced online banking services throughout the region. In the Middle East, new relationship managers were hired in the UAE, and HSBC entered the small business segment in Bahrain, Qatar and Jordan. In mainland China, local incorporation helped increase lending as the branch network expanded. HSBC was the first international bank to set up a rural branch, targeting businesses in the agricultural sector. In India, the addition of new staff in the branch network helped lift lending balances.

In North America, corporate and commercial lending rose by 15 per cent, led by Canada, where balances increased by 24 per cent. In the US, loan growth in Commercial Banking resulted primarily from strong activity in middle market lending, despite a slowdown in commercial real estate activity. 2007 saw an extension of middle market activities in Chicago, Washington DC and the West Coast as HSBC continued its branch expansion programme. Global Banking and Markets funded a number of facilities in connection with its participation on leveraged and acquisition finance syndicates, which added to loan balance growth in the US. In Canada, lending balances rose against the backdrop of strong economic growth, particularly in Western Canada.

Corporate and commercial lending in Latin America rose by 6 per cent as HSBC expanded its network of International Banking Centres and launched new initiatives to gain customers in the small and micro-business segments. In Mexico, volumes grew in commercial real estate lending, trade and factoring. The loan portfolio in Brazil grew strongly, led by increases in volumes in the *giro facil* product, guaranteed account, rural loans and working capital financing.

**Loans and advances to the financial sector** rose by 53 per cent to US\$99 billion. The increase was primarily due to Europe, up 45 per cent, in line with the strategy to expand the capital-efficient client-driven reverse repo business. In North America, lending to the financial sector rose by 65 per cent, due to substantial growth in balances with securities brokers and other financial institutions, as excess liquidity was invested in



reverse repos rather than Fed funds.

**Loans and advances to banks** increased by 23 per cent to US\$237 billion. Lending to banks in Hong Kong rose by 27 per cent and in Rest of Asia-Pacific by 39 per cent, due to growth in customer deposits across the region and increase in money market placements. In Europe, lending to banks rose by 28 per cent, due to project and money market loans in the UK and reverse repo lending in France.

The following tables analyse loans by industry sector and by the location of the principal operations of the lending subsidiary or, in the case of the operations of The Hongkong and Shanghai Banking Corporation, HSBC Bank, HSBC Bank Middle East and HSBC Bank USA, by the location of the lending branch.

[Back to Contents](#)**Loans and advances to banks by geographical region**

	Europe US\$m	Hong Kong US\$m	Rest of Asia- Pacific US\$m	North America US\$m	Latin America US\$m	Gross loans and advances to banks US\$m	Impairment allowances <sup>1</sup> US\$m
At 31 December 2007 (audited)	104,534	63,737	39,861	16,566	12,675	237,373	(7)
At 31 December 2006 (audited)	76,837	50,359	27,517	17,865	12,634	185,212	(7)
At 31 December 2005 (audited)	44,369	42,751	19,559	10,331	8,964	125,974	(9)
At 31 December 2004 (unaudited)	56,063	45,710	14,890	20,911	5,892	143,466	(17)
At 31 December 2003 (unaudited)	51,806	38,639	12,948	6,852	6,955	117,200	(24)

1 2003 and 2004: provisions for bad and doubtful debts.

**Loans and advances to customers by industry sector and by geographical region***(Audited)***At 31 December 2007**

	Europe US\$m	Hong Kong US\$m	Rest of Asia- Pacific US\$m	North America US\$m	Latin America US\$m	Gross loans and advances to customers US\$m	Gross loans by industry sector as a % of total gross loans %
<b>Personal</b>							
Residential mortgages <sup>1</sup>	95,665	29,689	20,397	118,993	4,324	269,068	26.9
Other personal	72,884	13,344	16,513	111,569	17,456	231,766	23.2
	<u>168,549</u>	<u>43,033</u>	<u>36,910</u>	<u>230,562</u>	<u>21,780</u>	<u>500,834</u>	<u>50.1</u>
<b>Corporate and commercial</b>							
Commercial, industrial and international trade	120,359	17,740	36,461	13,937	13,541	202,038	20.1
Commercial real estate	36,672	12,301	7,592	14,561	1,219	72,345	7.2
Other property-related	11,275	8,168	4,664	8,000	1,800	33,907	3.4
Government	2,299	332	1,667	248	1,162	5,708	0.6
Other commercial <sup>2</sup>	54,677	5,175	10,058	12,152	4,711	86,773	8.7
	<u>225,282</u>	<u>43,716</u>	<u>60,442</u>	<u>48,898</u>	<u>22,433</u>	<u>400,771</u>	<u>40.0</u>

**Financial**

Non-bank financial institutions	<b>61,216</b>	<b>2,483</b>	<b>5,191</b>	<b>22,252</b>	<b>5,639</b>	<b>96,781</b>	<b>9.7</b>
Settlement accounts	<b>1,159</b>	<b>782</b>	<b>235</b>	<b>128</b>	<b>63</b>	<b>2,367</b>	<b>0.2</b>
	<b>62,375</b>	<b>3,265</b>	<b>5,426</b>	<b>22,380</b>	<b>5,702</b>	<b>99,148</b>	<b>9.9</b>
Total gross loans and advances to customers <sup>3</sup>	<b>456,206</b>	<b>90,014</b>	<b>102,778</b>	<b>301,840</b>	<b>49,915</b>	<b>1,000,753</b>	<b>100.0</b>
Percentage of Group loans and advances by geographical region	<b>45.6%</b>	<b>9.0%</b>	<b>10.2%</b>	<b>30.2%</b>	<b>5.0%</b>	<b>100.0%</b>	
Impaired loans	<b>6,254</b>	<b>433</b>	<b>1,088</b>	<b>8,384</b>	<b>2,145</b>	<b>18,304</b>	
Impaired loans as a percentage of gross loans and advances to customers	<b>1.4%</b>	<b>0.5%</b>	<b>1.1%</b>	<b>2.8%</b>	<b>4.3%</b>	<b>1.8%</b>	
Impairment allowances on impaired loans	<b>3,049</b>	<b>144</b>	<b>552</b>	<b>7,176</b>	<b>1,366</b>	<b>12,287</b>	
Impairment allowances on impaired loans as a percentage of impaired loans	<b>48.8%</b>	<b>33.3%</b>	<b>50.7%</b>	<b>85.6%</b>	<b>63.7%</b>	<b>67.1%</b>	

1 Includes Hong Kong Government Home Ownership Scheme loans of US\$3,942 million.

2 Other commercial loans and advances include advances in respect of agriculture, transport, energy and utilities.

3 Included within this total is credit card lending of US\$82,854 million.

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HSBC HOLDINGS PLC

**Report of the Directors: The Management of Risk** (continued)

Credit risk &gt; Exposure &gt; By industry sector

**Loans and advances to customers by industry sector and by geographical region**  
(Audited)

At 31 December 2006

	Europe US\$m	Hong Kong US\$m	Rest of Asia- Pacific US\$m	North America US\$m	Latin America US\$m	Gross loans and advances to customers US\$m	Gross loans by industry sector as a % of total gross loans %
<b>Personal</b>							
Residential mortgages <sup>1</sup>	91,534	28,743	17,478	123,955	3,627	265,337	30.1
Other personal	67,214	10,396	13,275	108,256	11,668	210,809	23.9
	<u>158,748</u>	<u>39,139</u>	<u>30,753</u>	<u>232,211</u>	<u>15,295</u>	<u>476,146</u>	<u>54.0</u>
<b>Corporate and commercial</b>							
Commercial, industrial and international trade	99,027	16,845	25,196	11,004	10,037	162,109	18.4
Commercial real estate	28,655	12,481	5,502	12,782	946	60,366	6.8
Other property-related	9,616	6,923	3,491	5,931	1,204	27,165	3.1
Government	2,360	551	1,916	220	3,943	8,990	1.0
Other commercial <sup>2</sup>	56,650	5,553	8,468	9,736	4,070	84,477	9.6
	<u>196,308</u>	<u>42,353</u>	<u>44,573</u>	<u>39,673</u>	<u>20,200</u>	<u>343,107</u>	<u>38.9</u>
<b>Financial</b>							
Non-bank financial institutions	40,055	2,332	2,926	12,258	1,633	59,204	6.7
Settlement accounts	1,064	823	223	1,092	52	3,254	0.4
	<u>41,119</u>	<u>3,155</u>	<u>3,149</u>	<u>13,350</u>	<u>1,685</u>	<u>62,458</u>	<u>7.1</u>
<b>Total gross loans and advances to customers<sup>3</sup></b>	<u>396,175</u>	<u>84,647</u>	<u>78,475</u>	<u>285,234</u>	<u>37,180</u>	<u>881,711</u>	<u>100.0</u>
	44.9%	9.6%	8.9%	32.4%	4.2%	100.0%	

## Percentage of Group loans and advances by geographical region

Impaired loans	5,847	454	1,184	4,822	1,478	13,785
Impaired loans as a percentage of gross loans and advances to customers	1.5%	0.5%	1.5%	1.7%	4.0%	1.6%
Impairment allowances on impaired loans and advances <sup>4</sup>	2,934	148	590	3,825	1,025	8,522
Impairment allowances on impaired loans as a percentage of impaired loans <sup>4</sup>	50.2%	32.6%	49.8%	79.3%	69.4%	61.8%

1 Includes Hong Kong Government Home Ownership Scheme loans of US\$4,078 million.

2 Other commercial loans and advances include advances in respect of agriculture, transport, energy and utilities.

3 Includes credit card lending of US\$74,518 million.

4 Disclosures previously made in respect of 2006 have been amended to comply with 2007's presentation by excluding collective impairment allowances on loans and advances not classified as impaired. See page 226.

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At 31 December 2005

	Europe US\$m	Hong Kong US\$m	Rest of Asia- Pacific US\$m	North America US\$m	Latin America US\$m	Gross loans and advances to customers US\$m	Gross loans by industry sector as a % of total gross loans %
<b>Personal</b>							
Residential mortgages <sup>1</sup>	73,923	28,492	17,641	116,448	2,042	238,546	31.7
Other personal	55,672	9,978	11,178	97,663	7,439	181,930	24.2
	<u>129,595</u>	<u>38,470</u>	<u>28,819</u>	<u>214,111</u>	<u>9,481</u>	<u>420,476</u>	<u>55.9</u>
<b>Corporate and commercial</b>							
Commercial, industrial and international trade	76,687	16,736	21,286	10,375	5,718	130,802	17.4
Commercial real estate	22,071	12,557	5,081	11,714	392	51,815	6.9
Other property-related	7,603	6,147	3,426	4,447	573	22,196	3.0
Government	1,821	303	2,147	192	3,755	8,218	1.1
Other commercial <sup>2</sup>	41,944	6,922	7,716	7,189	1,907	65,678	8.7
	<u>150,126</u>	<u>42,665</u>	<u>39,656</u>	<u>33,917</u>	<u>12,345</u>	<u>278,709</u>	<u>37.1</u>
<b>Financial</b>							
Non-bank financial institutions	35,305	1,966	2,202	9,464	1,095	50,032	6.7
Settlement accounts	1,002	505	175	416	44	2,142	0.3
	<u>36,307</u>	<u>2,471</u>	<u>2,377</u>	<u>9,880</u>	<u>1,139</u>	<u>52,174</u>	<u>7.0</u>
<b>Total gross loans and advances to customers<sup>3</sup></b>	<u>316,028</u>	<u>83,606</u>	<u>70,852</u>	<u>257,908</u>	<u>22,965</u>	<u>751,359</u>	<u>100.0</u>
<b>Percentage of Group loans and advances by geographical region</b>	42.1%	11.1%	9.4%	34.3%	3.1%	100.0%	
<b>Impaired loans</b>	5,068	506	936	3,710	1,226	11,446	
<b>Impaired loans as a percentage of gross loans and advances to customers</b>	1.6%	0.6%	1.3%	1.4%	5.3%	1.5%	
<b>Impairment allowances on impaired loans and advances<sup>4</sup></b>	2,515	185	566	3,073	872	7,211	
	49.6%	36.6%	60.5%	82.8%	71.1%	63.0%	

Impairment allowances on  
impaired loans as a percentage  
of impaired loans<sup>4</sup>

- 1 *Includes Hong Kong Government Home Ownership Scheme loans of US\$4,680 million.*
- 2 *Other commercial loans and advances include advances in respect of agriculture, transport, energy and utilities.*
- 3 *Includes credit card lending of US\$66,020 million.*
- 4 *Disclosures previously made in respect of 2005 have been amended to comply with 2007's presentation by excluding collective impairment allowances on loans and advances not classified as impaired.*

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HSBC HOLDINGS PLC

**Report of the Directors: The Management of Risk** (continued)*Credit risk > Exposure > By industry sector***Loans and advances to customers by industry sector and by geographical region***(continued)**(Unaudited)*

At 31 December 2004

	Europe US\$m	Hong Kong US\$m	Rest of Asia- Pacific US\$m	North America US\$m	Latin America US\$m	Gross loans and advances to customers US\$m	Gross loans by industry sector as a % of total gross loans %
<b>Personal</b>							
Residential mortgages <sup>1</sup>	70,546	29,373	14,860	111,455	1,613	227,847	33.3
Other personal	57,920	9,105	9,079	78,984	4,917	160,005	23.3
	<u>128,466</u>	<u>38,478</u>	<u>23,939</u>	<u>190,439</u>	<u>6,530</u>	<u>387,852</u>	<u>56.6</u>
<b>Corporate and commercial</b>							
Commercial, industrial and international trade	55,018	14,132	19,177	9,544	4,005	101,876	14.9
Commercial real estate	18,917	10,388	4,232	9,712	220	43,469	6.3
Other property-related	6,850	5,959	3,350	4,266	324	20,749	3.0
Government	3,663	615	1,432	1,174	3,643	10,527	1.5
Other commercial <sup>2</sup>	34,185	7,294	7,015	5,173	1,484	55,151	8.1
	<u>118,633</u>	<u>38,388</u>	<u>35,206</u>	<u>29,869</u>	<u>9,676</u>	<u>231,772</u>	<u>33.8</u>
<b>Financial</b>							
Non-bank financial institutions	30,901	1,932	2,297	16,624	575	52,329	7.6
Settlement accounts	4,476	596	305	8,431	11	13,819	2.0
	<u>35,377</u>	<u>2,528</u>	<u>2,602</u>	<u>25,055</u>	<u>586</u>	<u>66,148</u>	<u>9.6</u>
	<u>282,476</u>	<u>79,394</u>	<u>61,747</u>	<u>245,363</u>	<u>16,792</u>	<u>685,772</u>	<u>100.0</u>



Total gross loans and advances  
to customers<sup>3</sup>

Percentage of Group loans and advances by geographical region	41.2%	11.6%	9.0%	35.8%	2.4%	100.0%
Impaired loans <sup>4,5</sup>	6,039	696	1,160	3,555	977	12,427
Impaired loans as a percentage of gross loans and advances <sup>4</sup>	2.1%	0.9%	1.9%	1.4%	5.8%	1.8%
Specific provisions outstanding against loans and advances <sup>5</sup>	4,036	320	785	4,106	770	10,017
Specific provisions outstanding as a percentage of impaired loans <sup>4,5</sup>	66.8%	46.0%	67.7%	115.5%	78.8%	80.6%

1 Includes Hong Kong Government Home Ownership Scheme loans of US\$5,383 million.

2 Other commercial loans and advances include advances in respect of agriculture, transport, energy and utilities.

3 Includes credit card lending of US\$56,222 million.

4 Net of suspended interest.

5 Included in North America are non-performing loans of US\$3,020 million and specific provisions of US\$3,443 million in HSBC Finance; excluding HSBC Finance, specific provisions outstanding as a percentage of non-performing loans was 54.6 per cent.

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	Europe US\$m	Hong Kong US\$m	Rest of Asia- Pacific US\$m	North America US\$m	Latin America US\$m	Gross loans and advances to customers US\$m	Gross loans by industry sector as a % of total gross loans %
<b>Personal</b>							
Residential mortgages <sup>1</sup>	51,721	29,954	12,101	76,485	1,493	171,754	31.6
Other personal	42,041	7,420	7,135	73,717	3,832	134,145	24.7
	<u>93,762</u>	<u>37,374</u>	<u>19,236</u>	<u>150,202</u>	<u>5,325</u>	<u>305,899</u>	<u>56.3</u>
<b>Corporate and commercial</b>							
Commercial, industrial and international trade	49,468	10,966	14,892	7,265	3,077	85,668	15.7
Commercial real estate	15,517	8,548	3,149	7,699	175	35,088	6.5
Other property-related	5,416	5,075	2,597	3,850	202	17,140	3.2
Government	2,462	927	1,450	375	4,376	9,590	1.8
Other commercial <sup>3</sup>	24,239	6,754	5,735	5,682	1,620	44,030	8.1
	<u>97,102</u>	<u>32,270</u>	<u>27,823</u>	<u>24,871</u>	<u>9,450</u>	<u>191,516</u>	<u>35.3</u>
<b>Financial</b>							
Non-bank financial institutions	21,226	4,921	2,027	8,588	329	37,091	6.8
Settlement accounts	3,068	556	188	4,767	15	8,594	1.6
	<u>24,294</u>	<u>5,477</u>	<u>2,215</u>	<u>13,355</u>	<u>344</u>	<u>45,685</u>	<u>8.4</u>
<b>Total gross loans and advances to customers<sup>4</sup></b>	<u>215,158</u>	<u>75,121</u>	<u>49,274</u>	<u>188,428</u>	<u>15,119</u>	<u>543,100</u>	<u>100.0</u>
<b>Percentage of Group loans and advances by geographical region</b>							
	39.6%	13.8%	9.1%	34.7%	2.8%	100.0%	
Non-performing loans <sup>6</sup>	5,701	1,671	1,538	4,889	1,251	15,050	
Non-performing loans as a percentage of gross loans and advances to customers <sup>5</sup>	2.6%	2.2%	3.1%	2.6%	8.3%	2.8%	
<b>Specific provisions outstanding against loans and advances<sup>6</sup></b>							
	3,554	629	981	4,660	1,054	10,878	
Specific provisions outstanding	62.3%	37.6%	63.8%	95.3%	84.3%	72.3%	

as a percentage of  
non-performing loans<sup>6</sup>

- 1 *Includes Hong Kong Government Home Ownership Scheme loans of US\$6,290 million.*
- 2 *Figures presented in this table were prepared in accordance with UK GAAP.*
- 3 *Other commercial loans include advances in respect of agriculture, transport, energy and utilities.*
- 4 *Includes credit card lending of US\$48,634 million.*
- 5 *Net of suspended interest.*
- 6 *Included in North America are non-performing loans of US\$4,335 million and specific provisions of US\$4,448 million in HSBC Finance; excluding HSBC Finance, specific provisions outstanding as a percentage of non-performing loans was 69.2 per cent.*

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HSBC HOLDINGS PLC

**Report of the Directors: The Management of Risk** (continued)*Credit risk > Exposure > Rest of Asia-Pacific and Latin America / Debt securities***Gross loans and advances to customers by principal country within Rest of Asia-Pacific and Latin America***(Audited)*

At 31 December 2007

	Residential mortgages US\$m	Other personal US\$m	Property-related US\$m	Commercial, international trade and other US\$m	Total US\$m
<b>Rest of Asia-Pacific</b>					
Australia	4,376	922	2,065	3,998	11,361
India	1,545	1,721	339	3,723	7,328
Indonesia	24	497	12	1,171	1,704
Japan	29	126	566	3,541	4,262
Mainland China	500	6	1,746	9,443	11,695
Malaysia	2,632	1,508	787	4,024	8,951
Middle East (excluding Saudi Arabia)	1,036	4,441	2,870	13,536	21,883
Egypt	□	196	126	1,575	1,897
United Arab Emirates	895	2,936	2,159	8,222	14,212
Other Middle East	141	1,309	585	3,739	5,774
Singapore	3,946	3,403	1,712	2,471	11,532
South Korea	2,596	880	61	3,608	7,145
Taiwan	2,061	648	□	1,072	3,781
Other	1,652	2,361	2,098	7,025	13,136
	<b>20,397</b>	<b>16,513</b>	<b>12,256</b>	<b>53,612</b>	<b>102,778</b>
<b>Latin America</b>					
Argentina	47	611	75	1,841	2,574
Brazil	329	10,110	426	8,601	19,466
Mexico	2,208	4,696	1,434	10,476	18,814
Panama	1,098	963	593	1,585	4,239
Other	642	1,076	491	2,613	4,822
	<b>4,324</b>	<b>17,456</b>	<b>3,019</b>	<b>25,116</b>	<b>49,915</b>

At 31 December 2006

Residential	Other	Property-	Commercial, international trade and
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	mortgages US\$m	personal US\$m	related US\$m	other US\$m	Total US\$m
Rest of Asia-Pacific					
Australia	3,637	586	1,615	2,951	8,789
India	1,338	1,067	203	2,363	4,971
Indonesia	17	371	2	1,014	1,404
Japan	18	131	648	2,601	3,398
Mainland China	377	9	1,504	4,226	6,116
Malaysia	2,456	1,277	589	3,537	7,859
Middle East (excluding Saudi Arabia)	434	3,134	1,733	10,595	15,896
Egypt	□	125	60	825	1,010
United Arab Emirates	331	1,982	1,308	6,624	10,245
Other Middle East	103	1,027	365	3,146	4,641
Singapore	3,090	3,225	1,286	2,052	9,653
South Korea	2,708	862	45	2,655	6,270
Taiwan	2,273	881	15	970	4,139
Other	1,130	1,732	1,353	5,765	9,980
	<u>17,478</u>	<u>13,275</u>	<u>8,993</u>	<u>38,729</u>	<u>78,475</u>
Latin America					
Argentina	22	314	52	1,625	2,013
Brazil	211	6,579	251	5,212	12,253
Mexico	1,801	3,353	959	8,648	14,761
Panama	1,101	854	604	1,642	4,201
Other	492	568	284	2,608	3,952
	<u>3,627</u>	<u>11,668</u>	<u>2,150</u>	<u>19,735</u>	<u>37,180</u>

[Back to Contents](#)**Debt securities and other bills by rating agency designation***(Audited)*

The following table presents an analysis by rating agency designation of debt and similar securities, other than loans, based on Standard & Poor's ratings

or their equivalent. Debt securities with short-term ratings are reported against the long-term rating of the issuer of the short-term debt securities. If major rating agencies have different ratings for the same debt securities, the securities are reported against the lower rating.

	Treasury bills US\$m	Other eligible bills US\$m	Debt securities US\$m	Total US\$m
<b>At 31 December 2007</b>				
AAA	13,234	229	199,310	212,773
AA $\square$ to AA+	17,470	263	99,357	117,090
A $\square$ to A+	11,082	300	67,402	78,784
Lower than A $\square$	2,577	293	28,995	31,865
Unrated	1,225	$\square$	37,481	38,706
Supporting liabilities under linked insurance and investment contracts <sup>1</sup>	51	$\square$	7,741	7,792
	<u>45,639</u>	<u>1,085</u>	<u>440,286</u>	<u>487,010</u>
Of which issued by:				
$\square$ governments	44,717	$\square$	164,848	209,565
$\square$ local authorities	287	$\square$	2,532	2,819
$\square$ asset-backed securities	$\square$	$\square$	94,555	94,555
$\square$ corporates and other	635	1,085	178,351	180,071
	<u>45,639</u>	<u>1,085</u>	<u>440,286</u>	<u>487,010</u>
Of which classified as:				
$\square$ trading assets	16,307	132	178,834	195,273
$\square$ financial instruments designated at fair value	181	$\square$	21,150	21,331
$\square$ available-for-sale securities	29,151	953	230,534	260,638
$\square$ held-to-maturity investments	$\square$	$\square$	9,768	9,768
	<u>45,639</u>	<u>1,085</u>	<u>440,286</u>	<u>487,010</u>
<b>At 31 December 2006</b>				
AAA	20,360	282	146,087	166,729
AA $\square$ to AA+	15,478	247	77,578	93,303
A $\square$ to A+	8,146	91	66,408	74,645
Lower than A $\square$	1,208	205	21,240	22,653
Unrated	1,134	$\square$	20,475	21,609
Supporting liabilities under linked insurance and investment contracts <sup>1</sup>	54	$\square$	4,304	4,358
	<u>46,380</u>	<u>825</u>	<u>336,092</u>	<u>383,297</u>

Of which issued by:				
<input type="checkbox"/> governments	44,941	<input type="checkbox"/>	120,369	165,310
<input type="checkbox"/> local authorities	370	<input type="checkbox"/>	8,704	9,074
<input type="checkbox"/> asset-backed securities	<input type="checkbox"/>	<input type="checkbox"/>	42,804	42,804
<input type="checkbox"/> corporates and other	1,069	825	164,215	166,109
	<u>46,380</u>	<u>825</u>	<u>336,092</u>	<u>383,297</u>
Of which classified as:				
<input type="checkbox"/> trading assets	21,751	8	155,447	177,206
<input type="checkbox"/> financial instruments designated at fair value	133	<input type="checkbox"/>	9,449	9,582
<input type="checkbox"/> available-for-sale securities	24,451	817	161,870	187,138
<input type="checkbox"/> held-to-maturity investments	45	<input type="checkbox"/>	9,326	9,371
	<u>46,380</u>	<u>825</u>	<u>336,092</u>	<u>383,297</u>

- 1 *For securities supporting liabilities under linked insurance and investment contracts, financial risks are substantially borne by the policyholders.*

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HSBC HOLDINGS PLC

## **Report of the Directors: The Management of Risk** (continued)

*Credit risk > Areas of special interest > Personal lending / US personal and mortgage lending*

Areas of special interest

### **Personal lending**

*(Unaudited)*

HSBC provides a broad range of secured and unsecured personal lending products to meet customer needs. Given the diverse nature of the markets in which HSBC operates, the range is not standardised in all countries but, along with the distribution channels used, is tailored to meet the demands of individual markets, while using common global IT platforms wherever possible.

Personal lending includes advances to customers for asset purchase, including residential property and motor vehicles, where such lending is typically secured on the assets to be acquired. HSBC also offers loans secured on existing assets, such as first and second liens on residential property; unsecured lending products such as overdrafts, credit cards and payroll loans; and debt consolidation loans which may be secured or unsecured.

Various underwriting controls are applied before the loan is issued, and loss in the event of delinquency is managed through collection and customer management procedures. The expected occurrence and degree of delinquency varies according to the type of loan and the customer segment. Delinquency levels tend to increase in the course of normal portfolio ageing. As a result, loan impairment charges usually relate to lending originated in earlier accounting periods.

The commentary that follows is on a constant currency basis.

At 31 December 2007, total personal lending was US\$501 billion, a rise of 3 per cent from 31 December 2006.

In 2007, loan impairment charges were primarily in personal lending, representing 94 per cent of the total charge. The three largest components were Personal Financial Services in North America (69 per cent), the UK (11 per cent) and Latin America (9 per cent).

HSBC recorded strong growth in Latin America, with gross loans and advances to personal customers rising by 31 per cent to US\$22 billion. Residential mortgage lending in the region increased by 18 per cent, while other personal lending rose by 34 per cent.

In Mexico, HSBC's other personal lending balances grew by 41 per cent in 2007 to US\$5 billion, predominantly from growth in credit card balances. In the same period, loan impairment charges rose by US\$574 million or 351 per cent, driven by strong growth in loan balances, a deterioration in credit quality and portfolio seasoning.

The credit quality of the US personal lending portfolio is discussed more fully below. In the UK, credit conditions were relatively benign, with loan impairment charges unchanged from 2006.



*Total personal lending  
(Unaudited)*

	<b>At 31 December 2007 US\$m</b>	At 31 December 2006 US\$m	At 31 December 2005 US\$m
Total US personal lending			
US Residential mortgages <sup>1</sup>	<b>98,816</b>	107,492	103,529
Motor vehicle finance	<b>13,266</b>	13,146	12,792
MasterCard and Visa credit cards	<b>32,223</b>	29,269	26,795
Private label cards	<b>17,411</b>	16,645	15,488
Other personal lending	<b>37,620</b>	41,214	35,545
	<b>199,336</b>	207,766	194,149
Residential mortgages, excluding the US	<b>170,252</b>	157,845	135,017
Other personal lending, excluding the US	<b>131,246</b>	110,535	91,310
	<b>500,834</b>	476,146	420,476

<sup>1</sup> *Includes residential mortgages of HSBC Bank USA and HSBC Finance.*

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## **US personal lending**

*(Unaudited)*

Total US personal lending fell by 4 per cent to US\$199 billion at 31 December 2007. Residential mortgage balances were US\$99 billion, a decline of 8 per cent, due to the continued run-down of the correspondent portfolio in mortgage services, the closure of the Decision One wholesale channel and tightened underwriting criteria in the branch-based consumer lending business, which curtailed growth.

Card balances rose by 8 per cent to US\$50 billion, but underlying growth slowed in the latter part of the year following the decision to reduce marketing and promotional activity in line with reduced risk appetite, as the US economy weakened. Motor vehicle finance loans rose by 1 per cent to US\$13 billion, driven by strong growth in the direct-to-consumer channel, partly offset by a flat performance from participating dealerships in the difficult economic environment.

Other personal lending fell by 9 per cent to US\$38 million due to tightening of underwriting criteria and a reduction in direct mail campaigns.

## **Mortgage lending products**

*(Unaudited)*

The Group offers a wide range of mortgage products designed to meet customer needs. This includes capital or principal repayment mortgages subject to fixed or variable interest rates, and products designed to meet demand for housing loans with more flexible payment structures. HSBC underwrites first lien residential mortgages and loans secured by second lien mortgages; the latter are reported within "Other personal lending" in the market sector analysis on page 216. The bulk of the mortgage lending products sold in the US consumer lending branch network are for refinancing and debt consolidation, rather than for house purchase.

Interest-only mortgages are those where customers make regular payments of interest during the life of the loan and repay the principal from the sale of their home or alternative sources of funds such as an endowment or other investment policy. Introductory interest-only mortgages are where the interest-only element is for a fixed term at the start of the loan, after which principal repayments commence. Affordability mortgages include all products where the customer's monthly payments are set at a low initial rate, either variable or fixed,

before resetting to a higher rate once the introductory period is over. These include ARMs, loans in which the interest rate is periodically changed based on an index.

HSBC has not offered, and does not anticipate offering, ARMs with alternative payment options or other negative amortisation products.

Affordability mortgages are primarily offered in the US and the UK. Under the HFC and Beneficial brands, HSBC Finance offers a range of products and delivery channels designed for the needs of customers with non-standard or less favourable credit profiles. In the US, such mortgages experienced heightened levels of delinquency in late 2006 and 2007. As a result, HSBC Finance took a series of steps designed to curtail mortgage lending: the mortgage services business ceased acquiring new mortgages; the consumer lending business halted its small volume of ARM loan originations, tightened underwriting criteria and loan-to-income requirements, and reduced loan-to-value ratios for first and second lien loans. These measures reduced HSBC Finance's mortgage balances to US\$91 billion at 31 December 2007 (2006: US\$99 billion) as set out in the table below.

In the UK, affordability mortgages stood at US\$35 billion at 31 December 2007, compared with US\$33 billion at 31 December 2006. Overall credit quality improved following measures taken in the recent past to tighten underwriting standards and improve the credit quality of new business. Delinquency rates on mortgages in the UK offered through HSBC Finance remained stable throughout 2007, with delinquency rates for loans offered in 2006 and 2007 lower than in the preceding two years.

In the rest of the UK business, loan impairment charges in the second half of 2007 were lower than in the first half of the year, as overall credit quality improved following recent measures to tighten underwriting standards

and improve the credit quality of new business. Although losses from mortgage lending remained low, maximum loan-to-value ratios were reduced during the year to mitigate the effects of a possible housing market downturn.

The following table shows the levels of mortgage lending products in the various portfolios of HSBC Finance and the rest of the HSBC Group:

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**Report of the Directors: The Management of Risk** (continued)*Credit risk > Areas of special interest > US personal and mortgage lending**Mortgage lending products*  
(Unaudited)

	At 31 December 2007			At 31 December 2006			At 31 December 2005		
	HSBC Finance <sub>1</sub> US\$m	Other US\$m	Total US\$m	HSBC Finance <sub>1</sub> US\$m	Other US\$m	Total US\$m	HSBC Finance <sub>1</sub> US\$m	Other US\$m	Total US\$m
Total mortgage lending <sup>2</sup>	<b>90,787</b>	<b>199,805</b>	<b>290,592</b>	99,150	189,348	288,498	85,662	171,491	257,153
Interest-only (including endowment) mortgages <sup>3,4</sup>	□	<b>34,425</b>	<b>34,425</b>	□	33,190	33,190	□	27,418	27,418
Affordability mortgages, including ARMs	<b>19,218</b>	<b>60,426</b>	<b>79,644</b>	30,169	60,106	90,275	25,244	56,396	81,640
Other	<b>85</b>	<b>1,078</b>	<b>1,163</b>	□	295	295	□	388	388
Total interest-only and affordability mortgages	<b>19,303</b>	<b>95,929</b>	<b>115,232</b>	30,169	93,591	123,760	25,244	84,202	109,446
As a percentage of total mortgage lending	<b>21.3%</b>	<b>48.0%</b>	<b>39.7%</b>	30.4%	49.4%	42.9%	29.5%	49.1%	42.6%
Second lien mortgages	<b>16,820</b>	<b>4,704</b>	<b>21,524</b>	19,420	4,938	24,358	15,338	4,526	19,864
As a percentage of total mortgage lending	<b>18.5%</b>	<b>2.4%</b>	<b>7.4%</b>	19.6%	2.6%	8.4%	17.9%	2.6%	7.7%

Negative equity mortgages <sup>5</sup>	<b>11,360</b>	<b>997</b>	<b>12,357</b>	12,347	2,450	14,797	14,168	2,328	16,496
Other loan to value ratios greater than 90 per cent <sup>6</sup>	<b>42,121</b>	<b>13,317</b>	<b>55,438</b>	45,712	19,608	65,320	35,514	20,468	55,982
	<b>53,481</b>	<b>14,314</b>	<b>67,795</b>	58,059	22,058	80,117	49,682	22,796	72,478
As a percentage of total mortgage lending	<b>58.9%</b>	<b>7.2%</b>	<b>23.3%</b>	58.6%	11.6%	27.8%	58.0%	13.3%	28.2%

- HSBC Finance is shown on a management basis and includes lending in Canada and the UK and loans transferred to HSBC USA Inc. which are managed by HSBC Finance.*
- Total mortgage lending includes residential mortgages and second lien mortgage lending reported within [Other personal lending].*
- Excludes introductory interest-only loans.*
- Some mortgage lending products are included in more than one, or none, of the types of mortgage specified in this table.*
- Negative equity arises when the value of the loan exceeds the value of available equity, and is generally based on values at origination date.*
- Loan to value ratios are generally based on values at origination date.*

### **HSBC Finance mortgage lending**

*(Unaudited)*

HSBC Finance held approximately US\$91 billion of residential mortgage loans and advances to personal customers at 31 December 2007, 18 per cent of the Group's gross loans and advances to personal customers.

At 31 December 2007, the balance outstanding of introductory interest-only loans in the US mortgage services business was US\$4 billion, compared with US\$6 billion in 2006, a decline of 36 per cent. No such loans were advanced in the consumer lending business.

The outstanding balance of ARMs in the US mortgage services business at 31 December 2007 was US\$16 billion, a decrease of 41 per cent,

compared with the end of 2006. In the consumer lending business, adjustable-rate loans fell by 16 per cent to US\$3 billion following the decision to cease the sale of these products in August 2007.

Second lien loans extended through the mortgage services business decreased by 33 per cent to US\$7 billion, while the consumer lending business recorded a 6 per cent increase to US\$7 billion.

The balance of HSBC Finance's stated-income mortgages was approximately US\$8.3 billion at the end of 2007 (2006: US\$11.8 billion), all of which were held by mortgage services. The consumer lending business did not originate any stated-income mortgages in either period.



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*HSBC Finance mortgage lending<sup>1</sup>*  
(Unaudited)

	Year ended 31 December 2007			Year ended 31 December 2006 <sup>2</sup>			Year ended 31 December 2005		
	Mortgage services US\$m	Consumer lending US\$m	Other mortgage lending <sup>3</sup> US\$m	Mortgage services US\$m	Consumer lending US\$m	Other mortgage lending <sup>3</sup> US\$m	Mortgage services US\$m	Consumer lending US\$m	Other mortgage lending <sup>3</sup> US\$m
Fixed-rate	<b>20,146</b>	<b>47,254</b>	<b>2,597</b>	22,358	42,378	2,210	20,088	36,187	1,000
Adjustable-rate and introductory rate	<b>16,070</b>	<b>2,970</b>	<b>1,750</b>	27,114	3,528	1,562	24,211	1,796	1,000
<b>Total</b>	<b>36,216</b>	<b>50,224</b>	<b>4,347</b>	49,472	45,906	3,772	44,299	37,983	3,000
First lien	<b>29,475</b>	<b>43,366</b>	<b>1,126</b>	39,404	39,406	920	36,278	33,242	1,000
Second lien	<b>6,741</b>	<b>6,858</b>	<b>3,221</b>	10,068	6,500	2,852	8,021	4,741	2,000
<b>Total</b>	<b>36,216</b>	<b>50,224</b>	<b>4,347</b>	49,472	45,906	3,772	44,299	37,983	3,000
Adjustable-rate	<b>12,361</b>	<b>2,970</b>	<b>1,748</b>	21,344	3,528	1,562	19,037	1,796	1,000
Introductory interest-only	<b>3,709</b>	□	<b>2</b>	5,770	□	□	5,174	□	□
<b>Total</b>	<b>16,070</b>	<b>2,970</b>	<b>1,750</b>	27,114	3,528	1,562	24,211	1,796	1,000

1 *Management basis.*

2 *Restated to show HSBC Finance management basis, consistent with the current year.*

3 *Includes balances in the UK and Canada.*

### US personal lending credit quality

(Unaudited)

In 2007, a cycle of declining house prices, reduced availability of mortgage finance and growing customer delinquency and default caused a deterioration in credit quality of increasing intensity.

Housing markets in a large part of the US have been affected by a broad-based slowdown in the rate of appreciation in property values, with actual declines in many markets, including California, Florida and Arizona, where earlier price increases had been significant. The S&P/Case-Shiller 10-City Composite Index showed a record decline in house prices of 8.4 per cent in the year to November 2007.

There was a high degree of correlation between the increase in delinquency throughout 2007 and declining house prices. Two months or more delinquencies rose most rapidly in those states which, prior to 2007, demonstrated superior credit performance, the greatest rate of appreciation and the highest home values.

The rising level of delinquencies led investors to question the reliability of credit ratings, not only for residential mortgage-backed securities but for a wide range of structured credit products. Investors became increasingly unwilling to purchase securitised credit, leading to a sharp contraction in flows of credit through the

affected channels. The exit of a number of participants in the sub-prime mortgage industry, together with a tightening of underwriting criteria by

remaining providers, led to fewer refinancing options for customers. This created particular problems for borrowers with affordability mortgages who faced a considerable increase in their monthly repayments at the end of their discounted introductory periods.

Within HSBC's portfolio, the rise in delinquencies, first reported in 2006 in the sub-prime second lien mortgages within the mortgage services business, spread initially to other parts of mortgage services, then to the branch-based consumer lending business and, in the closing months of the year, to the credit card business as the US economy weakened and credit availability contracted.

Loans originated in 2005, 2006 and early 2007 experienced worse credit performance than earlier vintages. The highest delinquency rates were in second lien loans whose borrowers also had first lien loans that were ARMs.

In addition, a significant number of second lien customers had underlying ARMs that faced repricing in the near term. As the interest rate adjustments occurred in an environment of lower house prices and tightening credit, the probability of default was greater than generally experienced prior to 2007.

Second lien loans have a heightened risk profile, for the reasons noted above. These loans often have higher loan-to-value ratios because, in many cases, the second lien loan was necessary to



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HSBC HOLDINGS PLC

**Report of the Directors: The Management of Risk** (continued)

*Credit risk > Areas of special interest > US personal lending / Loan delinquency in US*

*HSBC Finance: geographical concentration of US lending<sup>1</sup> (Unaudited)*

	<b>Mortgage lending as a percentage of:</b>		<b>Other personal lending as a percentage of</b>		<b>Percentage of total lending</b>
	<b>total lending</b>	<b>total mortgage lending</b>	<b>total lending</b>	<b>total other personal lending</b>	
	<b>%</b>	<b>%</b>	<b>%</b>	<b>%</b>	<b>%</b>
California	<b>6</b>	<b>12</b>	<b>6</b>	<b>12</b>	<b>12</b>
Florida	<b>4</b>	<b>7</b>	<b>3</b>	<b>7</b>	<b>7</b>
New York	<b>3</b>	<b>6</b>	<b>3</b>	<b>6</b>	<b>6</b>
Texas	<b>2</b>	<b>3</b>	<b>4</b>	<b>8</b>	<b>6</b>
Ohio	<b>3</b>	<b>5</b>	<b>2</b>	<b>5</b>	<b>5</b>
Pennsylvania	<b>3</b>	<b>5</b>	<b>2</b>	<b>5</b>	<b>5</b>

<sup>1</sup> *By states which individually account for 5 per cent or more of HSBC Finance's US customer loan portfolio.*

complete the purchase of the property. For second lien mortgages, the proportion of customers two months or more behind on contractual payments rose from 3.97 per cent at 31 December 2006 to 9.02 per cent at the end of 2007. Loss on default of second lien loans approaches 100 per cent of the amount owed as any collateral in the property is applied initially to the first lien loan.

Stated-income mortgages are also of above average risk as these were underwritten on the basis of borrowers' representations of annual income, not verified by receipt of supporting documentation. In HSBC Finance mortgage services, two months or more delinquency rates on stated-income loans rose from 6.36 per cent at 31 December 2006 to 19.01 per cent at 31 December 2007. In part, the percentage rise is due to a decline in loan balances as the mortgage loan portfolio is run off.

In mortgage services, the deterioration in credit performance first reported in 2006 continued. In the second half of 2007, credit quality became progressively worse due to the market conditions discussed above. Two months or more delinquencies increased from US\$2.3 billion, 4.64 per cent of loans and advances at the end of 2006, to US\$4.1 billion, 11.24 per cent at 31 December 2007. The increase in the delinquency rate was partly due to the reduction in the size of the portfolio.

In response, HSBC took several management actions to reposition the US consumer business. In March 2007, it took the decision to cease purchasing mortgages from third party correspondents. In September 2007, the Group closed its wholesale business, Decision One, ending new originations for the mortgage services business.

The branch-based consumer lending business experienced relatively stable performance in its portfolio throughout 2006 and into the first half of

2007. Starting in the fourth quarter of 2006, delinquencies began to rise in loans of 2005 and later vintages, to levels above what had been previously experienced. This trend was also seen in the rest of the industry. It is clear that, for some time, equity withdrawal has been the principal source of credit available to sub-prime borrowers dealing with unforeseen financial needs. Declining house prices and an industry-wide tightening of underwriting criteria have significantly reduced the ability of consumers to refinance. Starting from the third quarter, these factors had a marked effect on consumer lending delinquency. Two months or more delinquencies rose from 2.22 per cent at 31 December 2006 to 4.18 per cent of loans and advances at the end of 2007. Delinquent balances doubled to US\$2.1 billion. In this environment, HSBC took steps to tighten underwriting standards, including decreasing the loan to value ratio for residential mortgages and ceasing to underwrite certain products. To match the consequent reduction in demand and risk appetite, the network was reduced from nearly 1,400 branches to some 1,000.

HSBC also sold parts of the loan portfolio when opportunities arose at suitable valuations. In the first half of 2007, a total of US\$2.7 billion of mortgage services loans that did not include any loans 30 days or more delinquent were sold.

Credit card delinquencies of two months or more rose from 4.48 per cent at the end of 2006 to 5.68 per cent of receivables at 31 December 2007. In part, this was due to a change in product mix, as originations in the sub-prime and near-prime parts of the portfolio grew at faster rates than the overall portfolio. There was also an increase in bankruptcy rates as levels moved closer to historical norms following the exceptionally low level of filings seen during 2006. Additionally, in the fourth quarter of 2007, delinquencies began to rise in all vintages, particularly in the markets experiencing

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the greatest home value depreciation, driven by rising unemployment rates in these markets and a weakening US economy.

In vehicle finance, two months or more delinquencies moved from 3.16 per cent at the end of 2006 to 3.68 per cent at 31 December 2007. The increased delinquency in the vehicle finance portfolio was not as severe as has been experienced elsewhere in the industry. In 2007, the vehicle finance business tightened underwriting criteria in both the dealer and direct-to-consumer channels, to convert the mix of new loans to a higher credit quality.

HSBC has been proactive in reaching out to customers to provide financial counselling and assist them in restructuring their debts to avoid foreclosure. As a consequence, HSBC restructured and modified loans that it believed could be serviced, in line with local policies. In particular, customers with ARM loans approaching the first reset were contacted in order to assess their ability to make the higher payments and, where appropriate, to refinance or modify their loans.

As a result, in 2007 HSBC has modified more than 8,500 loans with an aggregate balance of more than US\$1.4 billion.

In 2007, approximately US\$4.5 billion of ARM loans reached their first interest rate reset. In 2008, approximately US\$6.5 billion of ARMs will reach their first interest rate reset, of which US\$2.8 billion relates to HSBC Bank USA and US\$3.7 billion to HSBC Finance. Within the latter, US\$2.7 billion is in mortgage services, the remainder in consumer lending. ARMs in HSBC Bank USA are largely prime balances. Delinquency rates are expected to continue to rise in 2008, as the limiting of originations means that the portfolio will mostly be running off. A deterioration in economic conditions and the housing market would also increase delinquencies.

### Loan delinquency in the US

(Unaudited)

The following tables provide a detailed analysis of loan delinquency in the US.

#### Two months and over contractual delinquency in Personal Financial Services in the US

(Unaudited)

	Quarter ended							
	31 December 2007 US\$m	30 September 2007 US\$m	30 June 2007 US\$m	31 March 2007 US\$m	31 December 2006 US\$m	30 September 2006 US\$m	30 June 2006 US\$m	31 March 2006 US\$m
Residential mortgages <sup>1</sup>	5,404	3,868	2,992	2,703	2,733	2,335	1,999	1,892
Second lien mortgage lending <sup>1</sup>	1,589	1,240	941	855	810	580	416	352
Vehicle finance <sup>2</sup>	488	451	384	302	415	421	367	292
Credit card	1,830	1,581	1,314	1,274	1,312	1,217	1,089	1,100
Private label	598	536	434	429	471	444	419	373
Personal non-credit	2,634	2,238	2,000	1,881	1,888	1,696	1,518	1,518

card								
Total <sup>1</sup>	12,543	9,914	8,065	7,444	7,629	6,693	5,808	5,527
	% <sub>3</sub>	% <sub>3</sub>	% <sub>3</sub>	% <sub>3</sub>	% <sub>3</sub>	% <sub>3</sub>	% <sub>3</sub>	% <sub>3</sub>
Residential mortgages <sup>1</sup>	5.47	3.83	2.92	2.54	2.54	2.19	1.89	1.81
Second lien mortgage lending <sup>1</sup>	9.02	6.81	5.02	4.35	3.97	2.79	2.03	1.81
Vehicle finance <sup>2</sup>	3.68	3.40	2.91	2.29	3.16	3.21	2.82	2.27
Credit card	5.68	5.09	4.32	4.43	4.48	4.46	4.09	4.28
Private label	3.43	3.28	2.72	2.65	2.83	2.88	2.84	2.60
Personal non-credit card	13.16	10.88	9.69	9.33	9.05	8.23	7.56	7.70
Total <sup>1</sup>	6.29	4.95	4.00	3.64	3.67	3.28	2.89	2.81

- 1 Consumer lending balances for the first three quarters of 2006 have been restated due to a reclassification of balances between first lien and second lien. Mortgage services balances for the second half of 2006 and the first half of 2007 have been restated due to a reclassification of assets between foreclosed and second lien.
- 2 In December 2006, the vehicle finance business changed its write-off policy to provide that the principal balance of vehicle loans in excess of the estimated net realisable value will be written off 30 days (previously 90 days) after the financed vehicle has been repossessed if it remains unsold, unless it becomes 150 days contractually delinquent, at which time such excess will be written off. This resulted in a one-time acceleration of write-offs totalling US\$24 million in December 2006. In connection with this policy change, the vehicle finance business also changed its methodology for reporting two months and over contractual delinquency to include loan balances associated with repossessed vehicles which have not yet been written down to net realisable value. This resulted in an increase of 42 basis points to the vehicle finance delinquency ratio and an increase of 3 basis points to the total consumer delinquency ratio.
- 3 Expressed as a percentage of loans and advances in Personal Financial Services in the US.

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HSBC HOLDINGS PLC

**Report of the Directors: The Management of Risk** (continued)*Credit risk > Cross border exposure / Credit quality**Two months and over contractual delinquency in mortgage services and consumer lending (Unaudited)*

	Quarter ended							
	31 December 2007 US\$m	30 September 2007 US\$m	30 June 2007 US\$m	31 March 2007 US\$m	31 December 2006 US\$m	30 September 2006 US\$m	30 June 2006 US\$m	31 March 2006 US\$m
Mortgage services:								
□ first lien	3,033	2,345	1,909	1,695	1,728	1,489	1,219	1,094
□ second lien <sup>1</sup>	1,038	832	660	595	570	405	263	184
Total mortgage services <sup>1</sup>	4,071	3,177	2,569	2,290	2,298	1,894	1,482	1,278
Consumer lending:								
□ first lien <sup>1</sup>	1,622	1,259	907	832	820	677	627	639
□ second lien <sup>1</sup>	478	346	236	220	200	143	133	154
Total consumer lending	2,100	1,605	1,143	1,052	1,020	820	760	793
	% <sub>2</sub>	% <sub>2</sub>	% <sub>2</sub>	% <sub>2</sub>	% <sub>2</sub>	% <sub>2</sub>	% <sub>2</sub>	% <sub>2</sub>
Mortgage services:								
□ first lien	10.29	7.46	5.76	4.53	4.39	3.68	3.04	2.80
□ second lien <sup>1</sup>	15.40	11.16	7.87	6.40	5.60	3.61	2.32	1.80
Total mortgage services <sup>1</sup>	11.24	8.17	6.19	4.90	4.64	3.67	2.88	2.59
Consumer lending:								
□ first lien <sup>1</sup>	3.74	2.92	2.15	2.03	2.08	1.85	1.78	1.88
□ second lien <sup>1</sup>	6.97	5.03	3.60	3.34	3.08	2.45	2.39	2.70
Total consumer lending	4.18	3.21	2.34	2.21	2.22	1.93	1.86	2.00

- Consumer lending balances for the first three quarters of 2006 have been restated due to a reclassification of balances between first lien and second lien. Mortgage services balances for the second half of 2006 and the first half of 2007 have been restated due to a reclassification of assets between foreclosed and second lien.*
- 2 *Expressed as a percentage of loans and advances in Personal Financial Services in the US.*

Country distribution of outstandings and cross-border exposures  
(Unaudited)

HSBC controls the risk associated with cross-border lending, essentially that foreign currency will not be made available to local residents to make payments, through a centralised structure of internal country limits which are determined by taking into account relevant economic and political factors. Exposures to individual countries and cross-border exposure in aggregate are kept under continual review.

The following table summarises the aggregate of in-country foreign currency and cross-border outstandings by type of borrower to countries which individually represent in excess of 1 per cent of

HSBC's total assets. The classification is based on the country of residence of the borrower but also recognises the transfer of country risk in respect of third party guarantees, eligible collateral held and residence of the head office when the borrower is a branch. In accordance with the Bank of England Country Exposure Report (Form CE) guidelines, outstandings comprise loans and advances (excluding settlement accounts), amounts receivable under finance leases, acceptances, commercial bills, CDs and debt and equity securities (net of short positions), and exclude accrued interest and intra-HSBC exposures.

[Back to Contents](#)**In-country foreign currency and cross-border outstandings***(Unaudited)*

	<b>Banks</b>	<b>Government and official institutions</b>	<b>Other</b>	<b>Total</b>
	<b>US\$bn</b>	<b>US\$bn</b>	<b>US\$bn</b>	<b>US\$bn</b>
<b>At 31 December 2007</b>				
UK	<b>32.3</b>	<b>2.2</b>	<b>47.5</b>	<b>82.0</b>
France	<b>14.0</b>	<b>11.4</b>	<b>29.5</b>	<b>54.9</b>
Germany	<b>38.8</b>	<b>1.7</b>	<b>1.9</b>	<b>42.4</b>
US	<b>30.3</b>	<b>5.9</b>	<b>5.6</b>	<b>41.8</b>
The Netherlands	<b>21.4</b>	<b>0.2</b>	<b>4.2</b>	<b>25.8</b>

## At 31 December 2006

UK	24.8	□	33.5	58.3
Germany	23.7	18.9	2.0	44.6
US	9.5	12.7	16.2	38.4
France	22.1	2.4	6.1	30.6
The Netherlands	14.4	2.1	3.9	20.4
Italy	4.7	12.5	1.4	18.6

## At 31 December 2005

UK	19.6	3.7	16.2	39.5
US	10.2	11.1	17.1	38.4
Germany	21.6	12.7	3.3	37.6
France	11.5	4.7	5.4	21.6
The Netherlands	11.9	2.6	4.4	18.9
Italy	4.4	10.6	3.5	18.5

At 31 December 2007, HSBC had in-country foreign currency and cross-border outstandings to counterparties in Hong Kong, Belgium and Ireland of between 0.75 per cent and 1.0 per cent of total assets. The aggregate in-country foreign currency and cross-border outstandings were: Hong Kong, US\$19.7 billion; Belgium, US\$19.3 billion and Ireland, US\$19.3 billion.

At 31 December 2006, HSBC had in-country foreign currency and cross-border outstandings to counterparties in Australia and Hong Kong of between 0.75 per cent and 1 per cent of total assets. The aggregate in-country foreign currency and cross-border outstandings were: Australia, US\$17.5 billion; Hong Kong, US\$15.5 billion.

At 31 December 2005, HSBC had in-country foreign currency and cross-border outstandings to counterparties in Hong Kong, Australia and Canada of between 0.75 per cent and 1 per cent of total assets. The aggregate in-country foreign currency and cross-border outstandings were: Hong Kong, US\$14.6 billion; Australia, US\$12.5 billion; Canada, US\$11.7 billion.

## Credit quality

The following tables reflect, with the principal exception of developments in US personal portfolios

that are extensively commented upon in □Areas of special interest□ above, broadly stable credit quality across the majority of the Group□s businesses.

Loans and advances that were neither past due nor impaired decreased marginally to 94.4 per cent (2006: 94.9 per cent) of total loans and advances. Among these, however, those classified as grades 1-3 (satisfactory risk) increased to 96.0 per cent (2006: 92.9 per cent).

The further deterioration in quality in, principally, US personal lending was reflected in an increase in the proportion of loans and advances to customers which were past due, though not impaired, to 5.1 per cent (2006: 4.6 per cent, following restatement). The great majority of such loans were in the band of past due up to 90 days.

The credit quality of loans and advances to banks remained broadly stable, showing overall a marginal improvement on its already favourable condition as at year-end 2006, and with a partial shift in the quality profile of neither past due nor impaired accounts being partly offset by a reduction in those that were past due.

Details of impaired loans and advances to customers, which increased from 1.56 per cent to 1.83 per cent of total loans and advances to customers, are commented on further below.



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HSBC HOLDINGS PLC

**Report of the Directors: The Management of Risk** (continued)*Credit risk > Credit quality > Loans and advances*

Loans and advances

**Distribution of loans and advances by credit quality***(Audited)*

	<b>At 31 December 2007</b>		At 31 December 2006	
	<b>Loans and advances to customers US\$m</b>	<b>Loans and advances to banks US\$m</b>	Loans and advances to customers <sup>1</sup> US\$m	Loans and advances to banks US\$m
Loans and advances:				
□ neither past due nor impaired	<b>931,872</b>	<b>237,339</b>	827,495	185,125
□ past due but not impaired	<b>50,577</b>	<b>22</b>	40,431	72
□ impaired	<b>18,304</b>	<b>12</b>	13,785	15
	<b>1,000,753</b>	<b>237,373</b>	881,711	185,212

1 The amounts reported in 2006 as □past due but not impaired□ have been amended to include certain loans previously classified as □neither past due nor impaired□. The reclassification reflects the fact that, while these loans are in early-stage arrears, a proportion arise from events unrelated to poor credit quality, and historical experience suggests that only a small percentage of such loans progresses through stages of delinquency to default. This reclassification has no effect on total impaired loans or impairment allowances.

**Distribution of loans and advances neither past due nor impaired***(Audited)*

The credit quality of the portfolio of loans and advances that were neither past due nor impaired can be assessed by reference to the Group's legacy

credit risk grading system, on which the following information is based:

	<b>At 31 December 2007</b>		At 31 December 2006	
	<b>Loans and advances to customers<sup>1</sup> US\$m</b>	<b>Loans and advances to banks US\$m</b>	Loans and advances to customers <sup>1</sup> US\$m	Loans and advances to banks US\$m
Grades:				
1 to 3 □ satisfactory risk	<b>886,432</b>	<b>236,314</b>	769,392	184,059
4 □ watch list and special mention	<b>39,229</b>	<b>504</b>	51,899	1,040
5 □ sub-standard but not impaired	<b>6,211</b>	<b>521</b>	6,204	26

<b>931,872</b>	<b>237,339</b>	827,495	185,125
----------------	----------------	---------	---------

- 1 *The majority of the loans and advances to customers that are operating within revised terms following restructuring, for details of which see [Renegotiated loans] below, are included in this table.*

Grades 1 and 2 include corporate facilities demonstrating financial condition, risk factors and capacity to repay that are good to excellent, residential mortgages with low to moderate loan to value ratios and other retail accounts which are maintained within generally applicable product parameters.

Grade 3 represents satisfactory risk, and includes corporate facilities that require closer monitoring, mortgages with higher loan to value ratios, credit card exposures and other retail exposures which operate outside generally applicable product parameters without being impaired.

Grades 4 and 5 include facilities that require varying degrees of special attention and all retail exposures that are progressively between 30 and 90 days past due (60 days for US motor loans).

Grades 6 or 7 represent impaired exposures.

Loans and advances which are individually assessed for impairment are identified on an individual basis and classified as grades 6 or 7 when they are impaired. It is not practicable to individually identify impaired loans and advances within portfolios of homogeneous loans which are assessed on a collective basis for impairment. In practice, such loans and advances are not individually identified as impaired until the time each impaired loan is written off. It is therefore necessary to estimate the carrying value of impaired loans and advances within these portfolios.

The approach adopted by HSBC to estimate the carrying value of impaired loans and advances within portfolios of homogeneous loans that are collectively assessed for impairment, is to classify these loans and advances as impaired when the

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balances are 90 days or more past due, except for US motor loans which are classified as impaired when 60 days or more past due. These loans and advances are classified as grades 6 and 7. All other collectively assessed loans and advances, including those which are less than 90 days past due (less than 60 days for US motor loans), are classified as not impaired and reported within grades 1 to 5. Collective impairment allowances are recognised in relation to losses that are likely to have been incurred at the balance sheet date on which they are collectively assessed for impairment and classified loans in grades 1 to 5, representing a small percentage of the total loans and advances in these grades.

### Loans and advances which were past due but not impaired

(Audited)

Examples of exposures designated past due but not considered impaired include loans that have missed the most recent payment date but on which there is no evidence of impairment; loans fully secured by cash collateral; residential mortgages in arrears more than 90 days, but where the value of collateral is sufficient to repay both the principal debt and all potential interest for at least one year; and short-term trade facilities past due more than 90 days for technical reasons such as delays in documentation, but where there is no concern over the creditworthiness of the counterparty.

	At 31 December 2007		At 31 December 2006	
	Loans and advances to customers <sup>1</sup> US\$m	Loans and advances to banks US\$m	Loans and advances to customers <sup>1</sup> US\$m	Loans and advances to banks US\$m
Past due up to 29 days	33,909	22	28,359	72
Past due 30-59 days	10,546	□	7,353	□
Past due 60-89 days	3,992	□	2,796	□
	<b>48,447</b>	<b>22</b>	<b>38,508</b>	<b>72</b>
Past due 90-179 days	1,767	□	1,764	□
Past due over 180 days	363	□	159	□
	<b>50,577</b>	<b>22</b>	<b>40,431</b>	<b>72</b>

1 The majority of the loans and advances to customers that are operating within revised terms following restructuring, for details of which see [Renegotiated loans] below, are excluded from this table.

This ageing analysis includes past due loans and advances on which collective impairment allowances

### Impaired loans and advances

(Audited)

have been assessed, though at their early stage of arrears there is no identifiable impairment as such.

### At 31 December

2007 US\$m	2006 US\$m
---------------	---------------

Total impaired loans and advances to:

□ banks	<b>12</b>	15
□ customers	<b>18,304</b>	13,785
	<u>18,316</u>	<u>13,800</u>

**Customer loans and advances and impairment allowances by geographical region**

*(Audited)*

The table below presents an analysis of the impairment allowances recognised for impaired loans and advances that are either individually

assessed or collectively assessed, and an analysis of collective impairment allowances on loans and advances classified as not impaired.

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HSBC HOLDINGS PLC

**Report of the Directors: The Management of Risk** (continued)

Credit risk > Credit quality > Loans and advances > 2007 /  
Renegotiated loans

	Individually assessed loans and advances to customers			Collectively assessed loans and advances to customers <sup>1</sup>			Total		
	Individual impairment allowances US\$m	Gross loans and advances US\$m	%	Collective impairment allowances US\$m	Gross loans and advances US\$m	%	Total impairment allowances US\$m	Gross loans and advances US\$m	%
<b>At 31 December 2007</b>									
Impaired loans and advances <sup>2</sup>									
Europe	1,846	4,558	40.5	1,203	1,696	70.9	3,049	6,254	48.8
Hong Kong	132	378	34.9	12	55	21.8	144	433	33.3
Rest of Asia-Pacific	349	678	51.5	203	410	49.5	552	1,088	50.7
North America	119	421	28.3	7,057	7,963	88.6	7,176	8,384	85.6
Latin America	253	442	57.2	1,113	1,703	65.4	1,366	2,145	63.7
	<b>2,699</b>	<b>6,477</b>	<b>41.7</b>	<b>9,588</b>	<b>11,827</b>	<b>81.1</b>	<b>12,287</b>	<b>18,304</b>	<b>67.1</b>
Collectively assessed loans and advances not impaired <sup>3</sup>									
Europe				882	449,952	0.2	882	449,952	0.2
Hong Kong				232	89,581	0.3	232	89,581	0.3
Rest of Asia-Pacific				374	101,690	0.4	374	101,690	0.4
North America				4,804	293,456	1.6	4,804	293,456	1.6
Latin America				626	47,770	1.3	626	47,770	1.3
				<b>6,918</b>	<b>982,449</b>	<b>0.7</b>	<b>6,918</b>	<b>982,449</b>	<b>0.7</b>
	<b>2,699</b>	<b>6,477</b>		<b>16,506</b>	<b>994,276</b>	<b>1.7</b>	<b>19,205</b>	<b>1,000,753</b>	<b>1.9</b>

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At 31 December 2006										
Impaired loans and advances <sup>2</sup>										
Europe	1,725	4,031	42.8	1,209	1,816	66.6	2,934	5,847	50.2	
Hong Kong	131	407	32.2	17	47	36.2	148	454	32.6	
Rest of Asia-Pacific	362	649	55.8	228	535	42.6	590	1,184	49.8	
North America	109	421	25.9	3,716	4,401	84.4	3,825	4,822	79.3	
Latin America	238	325	73.2	787	1,153	68.3	1,025	1,478	69.4	
	2,565	5,833	44.0	5,957	7,952	74.9	8,522	13,785	61.8	
Collectively assessed loans and advances not impaired <sup>3</sup>										
Europe				742	390,328	0.2	742	390,328	0.2	
Hong Kong				217	84,193	0.3	217	84,193	0.3	
Rest of Asia-Pacific				311	77,291	0.4	311	77,291	0.4	
North America				3,422	280,412	1.2	3,422	280,412	1.2	
Latin America				364	35,702	1.0	364	35,702	1.0	
				5,056	867,926	0.6	5,056	867,926	0.6	
	2,565	5,833		11,013	875,878	1.3	13,578	881,711	1.5	

- 1 *Collectively assessed loans and advances comprise homogeneous groups of loans that are not considered individually significant, and loans subject to individual assessment where no impairment has been identified on an individual basis, but on which a collective impairment allowance has been calculated to reflect losses which have been incurred but not yet identified.*
- 2 *Impaired loans and advances are grades 6 and 7 by reference to the Group's legacy credit rating system.*
- 3 *Collectively assessed loans and advances not impaired are grades 1 to 5 by reference to the Group's legacy credit rating system.*

Year ended 31 December 2007 compared with year ended 31 December 2006  
(Unaudited)

Total impaired loans to customers were US\$18.3 billion at 31 December 2007, an increase of 33 per cent since the end of 2006 (28 per cent at constant currency). Impaired loans were 2 per cent of gross customer loans and advances, broadly in

line with 31 December 2006.

The commentary that follows compares balances at 31 December 2007 with those at 31 December 2006, at constant exchange rates.

In **Europe**, impaired loans at US\$6.3 billion were 2 per cent higher than at the end of 2006. Higher impaired loans in France and Turkey were

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partly offset by a decline in the UK, where changes in underwriting practices resulted in a fall in personal unsecured lending in 2007.

In **Hong Kong**, impaired loans declined by 4 per cent to US\$433 million. Credit conditions were very favourable, reflecting the strong local economy and buoyant equity and property markets.

In **Rest of Asia-Pacific**, the decline in impaired loans of 11 per cent to US\$1.1 billion was mainly driven by lower impaired loans in Taiwan following the non-recurrence of the effect of regulatory changes which, in 2006, led to a significant increase in impaired loans. This was partly offset by a rise in impaired loans in India due to strong growth in personal lending.

In **North America**, HSBC recorded a 73 per cent increase in impaired loans to US\$8.4 billion at 31 December 2007. The consumer finance business in the US was responsible for the

bulk of the change. HSBC Finance experienced a deterioration in credit quality in most of its lending book, in particular for first and second lien mortgages originated in 2005 and 2006. In the final quarter of the year, in line with the market, delinquencies rose in the credit card portfolio, with a smaller rise in vehicle finance loans. A full discussion of these developments and their effect on credit quality is provided in the ["Areas of special interest"](#) commentary on page 216. In Canada, although impaired loans rose from a low base, credit conditions remained strong.

In **Latin America**, impaired loans increased by 30 per cent to US\$2.1 billion, primarily due to a rise of 76 per cent in impaired loans in Mexico. This was due to portfolio growth, seasoning and higher delinquency rates on credit cards. Revenues from this growth in credit card lending more than covered the rise in impairment charges.

### Individually impaired loans and advances to customers

(Audited)

	Europe US\$m	Hong Kong US\$m	Rest of Asia- Pacific US\$m	North America US\$m	Latin America US\$m	Gross impaired loans and advances to customers US\$m	% of total gross impaired loans <sup>1</sup> %
<b>At 31 December 2007</b>							
Individually impaired loans and advances to customers:							
□ personal	1,073	178	225	68	4	1,548	23.9
□ commercial and corporate	3,485	200	453	353	438	4,929	76.1
	<b>4,558</b>	<b>378</b>	<b>678</b>	<b>421</b>	<b>442</b>	<b>6,477</b>	<b>100.0</b>

At 31 December 2006  
Individually impaired loans and advances to customers:

□ personal	975	231	118	173	1	1,498	25.7
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□ commercial and corporate	3,056	176	531	248	324	4,335	74.3
	4,031	407	649	421	325	5,833	100.0

1 *Gross impaired loans by industry sector as a percentage of total gross impaired loans.*

### **Interest forgone on impaired loans**

*(Audited)*

Interest income that would have been recognised under the original terms of impaired and restructured loans amounted to approximately US\$1.1 billion in 2007 (2006: US\$0.7 billion). Interest income from such loans of approximately US\$374 million was recorded in 2007.

Renegotiated loans

*(Audited)*

Restructuring activity is designed to manage customer relationships, maximise collection

opportunities and, if possible, avoid foreclosure or repossession. Such activities include extended payment arrangements, approved external debt management plans, deferring foreclosure, modification, loan rewrites and/or deferral of payments pending a change in circumstances. Following restructuring, an overdue consumer account is normally reset from delinquent to current status. Restructuring policies and practices are based on indicators or criteria which, in the judgement of local management, indicate that repayment will probably continue. These policies are required to be kept under continual review and their application varies according to the nature of the market, the

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HSBC HOLDINGS PLC

**Report of the Directors: The Management of Risk** (continued)

*Credit risk > Credit quality > Renegotiated loans / Impairment allowances and charges*

product, and the availability of empirically based data. Criteria vary between products, but typically include: receipt of one or more qualifying payments within a certain period, a minimum lapse of time from origination before restructuring may occur, and restrictions on the number and/or frequency of successive restructurings. When empirical evidence indicates an increased propensity to default on restructured accounts, the use of roll rate methodology ensures this factor is taken into account when calculating impairment allowances.

Renegotiated loans that would otherwise be past due or impaired totalled US\$28 billion at 31 December 2007 (2006: US\$21 billion). Restructuring is most commonly applied to consumer finance portfolios. The largest concentration was in the US and amounted to US\$24 billion (2006: US\$17 billion) or 86 per cent (2006: 81 per cent) of the Group's total renegotiated loans. The increase was due to a significant deterioration in credit quality in the US. Most restructurings in the US related to loans secured on real estate.

**US loan modifications***(Unaudited)*

In October 2006, as part of its efforts to mitigate risk in the affected components of the mortgage services portfolio in the US, HSBC Finance established a new programme specifically designed to meet the needs of selected customers with ARMs. HSBC Finance is proactively calling and writing to customers who have ARM loans nearing their first reset that HSBC Finance expects will be the most affected by a rate adjustment. By a variety of means, HSBC Finance assesses the customer's ability to make the adjusted payment and, as appropriate and in accordance with defined policies, HSBC Finance modifies the loans, allowing time for the customer to seek alternative financing or improve their individual situation. These loan modifications primarily provide for temporary interest rate relief for 12 months by either maintaining the current interest rate for the entire 12-month period or resetting the interest rate for the 12-month period to a rate lower than that originally required at the reset date. At the end of the 12-month period, the interest rate on the loan will reset in accordance with the original loan terms, unless the borrower qualifies for, and is granted, a further modification. In 2007, HSBC Finance made more than 33,000 outbound contacts and modified more than 8,500 loans with an aggregate balance of

US\$1.4 billion. Since the inception of this programme, HSBC Finance has made more than 41,000 outbound contacts and modified more than 10,300 loans with an aggregate balance of US\$1.6 billion. These loans are not included in the figures quoted above, because HSBC Finance has not reset delinquency on them as they were not contractually delinquent at the time of the modification. However, loans which have been restructured in the past for other reasons are included in the figures above. HSBC Finance also continues to manage a Foreclosure Avoidance Programme for delinquent consumer lending customers designed to provide relief to qualifying home owners by either loan restructuring or modification. HSBC Finance also supports a variety of national and local efforts in home ownership preservation and foreclosure avoidance.

Collateral and other credit enhancements obtained

*(Audited)*

HSBC obtained assets by taking possession of collateral held as security, or calling upon other credit enhancements, as follows:

*(Audited)*

**Carrying amount  
obtained in:**

	2007 US\$m	2006 US\$m
<b>Nature of assets</b>		
Residential property	2,509	1,716
Commercial and industrial property	18	6
Other	373	215
	2,900	1,937

Repossessed properties are made available for sale in an orderly fashion, with the proceeds used to reduce or repay the outstanding indebtedness. Where excess funds are available after the debt has been repaid, they are available either for other secured lenders with lower priority or are returned to the customer. HSBC does not generally occupy repossessed properties for its business use. The majority of repossessed properties arose in the US in HSBC Finance, which experienced higher levels of foreclosure and higher losses on sale due to declining house prices. The average time taken to sell a foreclosed property in the US during 2007 was 184 days and the average loss on sale was 11 per cent. A quarterly breakdown is provided below:

[Back to Contents](#)*(Unaudited)*

	2007	Quarter ended			
		31 December 2007	30 September 2007	30 June 2007	31 March 2007
Number of foreclosed properties at end of period	<b>9,627</b>	9,627	8,809	9,115	9,161
Number of properties added to foreclosed inventory in the year/quarter	<b>18,755</b>	4,957	4,814	4,540	4,444
Average loss on sale of foreclosed properties <sup>1</sup>	<b>11%</b>	14%	9%	8%	10%
Average time to sell foreclosed properties (days)	<b>184</b>	183	186	185	183

1 *The average loss on sale of foreclosed properties is calculated as cash proceeds after deducting selling costs and commissions, minus the book value of the property when it was moved to Real estate owned, divided by the book value of the property when it was moved Real estate owned.*

### Impairment allowances and charges

#### Movement in allowance accounts for total loans and advances

*(Audited)*

	Individually assessed US\$m	Collectively assessed US\$m	Total US\$m
At 1 January 2007	2,572	11,013	13,585
Amounts written off	(897)	(11,947)	(12,844)
Recoveries of loans and advances written off in previous years	129	876	1,005
Charge to income statement	796	16,381	17,177
Exchange and other movements	106	183	289
<b>At 31 December 2007</b>	<b>2,706</b>	<b>16,506</b>	<b>19,212</b>
At 1 January 2006	2,679	8,687	11,366
Amounts written off	(1,023)	(8,450)	(9,473)
Recoveries of loans and advances written off in previous years	128	651	779
Charge to income statement	458	10,089	10,547
Exchange and other movements	330	36	366
At 31 December 2006	2,572	11,013	13,585

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HSBC HOLDINGS PLC

**Report of the Directors: The Management of Risk** (continued)*Credit risk > Impairment allowances and charges***Movement in impairment allowances by industry segment and by geographical region**

The following tables show details of the movements in HSBC's loan impairment allowances by location of lending office for each of the past five years.

A discussion of the material movements in the loan impairment charges by region follows these tables.

*(Audited)*

	<b>2007</b>					
	<b>Europe US\$m</b>	<b>Hong Kong US\$m</b>	<b>Rest of Asia- Pacific US\$m</b>	<b>North America US\$m</b>	<b>Latin America US\$m</b>	<b>Total US\$m</b>
Impairment allowances at 1 January	<b>3,683</b>	<b>365</b>	<b>901</b>	<b>7,247</b>	<b>1,389</b>	<b>13,585</b>
Amounts written off	<b>(2,940)</b>	<b>(251)</b>	<b>(724)</b>	<b>(7,444)</b>	<b>(1,485)</b>	<b>(12,844)</b>
Commercial, industrial and international trade	<b>(371)</b>	<b>(57)</b>	<b>(94)</b>	<b>(122)</b>	<b>(253)</b>	<b>(897)</b>
Real estate	<b>(72)</b>	<b>(4)</b>	<b>(5)</b>	<b>(14)</b>	<b>(3)</b>	<b>(98)</b>
Non-bank financial institutions	<b>(5)</b>	<b>□</b>	<b>□</b>	<b>(5)</b>	<b>(1)</b>	<b>(11)</b>
Other commercial	<b>(90)</b>	<b>(10)</b>	<b>(10)</b>	<b>(30)</b>	<b>(28)</b>	<b>(168)</b>
Residential mortgages	<b>(7)</b>	<b>(8)</b>	<b>(16)</b>	<b>(878)</b>	<b>(21)</b>	<b>(930)</b>
Other personal	<b>(2,395)</b>	<b>(172)</b>	<b>(599)</b>	<b>(6,395)</b>	<b>(1,179)</b>	<b>(10,740)</b>
Recoveries of amounts written off in previous years	<b>542</b>	<b>43</b>	<b>124</b>	<b>62</b>	<b>234</b>	<b>1,005</b>
Commercial, industrial and international trade	<b>14</b>	<b>5</b>	<b>10</b>	<b>21</b>	<b>24</b>	<b>74</b>
Real estate	<b>19</b>	<b>1</b>	<b>7</b>	<b>1</b>	<b>1</b>	<b>29</b>
Non-bank financial institutions	<b>8</b>	<b>□</b>	<b>1</b>	<b>2</b>	<b>□</b>	<b>11</b>
Other commercial	<b>33</b>	<b>1</b>	<b>6</b>	<b>9</b>	<b>5</b>	<b>54</b>
Residential mortgages	<b>□</b>	<b>6</b>	<b>3</b>	<b>1</b>	<b>9</b>	<b>19</b>
Other personal	<b>468</b>	<b>30</b>	<b>97</b>	<b>28</b>	<b>195</b>	<b>818</b>
Charge to income statement <sup>1</sup>	<b>2,543</b>	<b>212</b>	<b>614</b>	<b>12,111</b>	<b>1,697</b>	<b>17,177</b>
Banks	<b>□</b>	<b>□</b>	<b>□</b>	<b>□</b>	<b>□</b>	<b>□</b>
Commercial, industrial and international trade	<b>353</b>	<b>57</b>	<b>82</b>	<b>125</b>	<b>280</b>	<b>897</b>

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Real estate	119	(4)	(21)	52	6	152
Non-bank financial institutions	12	2	1	21	□	36
Governments	(3)	□	□	□	□	(3)
Other commercial	27	□	2	59	39	127
Residential mortgages	7	(14)	16	1,784	47	1,840
Other personal	2,028	171	534	10,070	1,325	14,128
Foreign exchange and other movements	110	7	11	4	157	289
Impairment allowances at 31 December	3,938	376	926	11,980	1,992	19,212
Impairment allowances against banks:						
□ individually assessed	7	□	□	□	□	7
Impairment allowances against customers:						
□ individually assessed	1,846	132	349	119	253	2,699
□ collectively assessed	2,085	244	577	11,861	1,739	16,506
Impairment allowances at 31 December	3,938	376	926	11,980	1,992	19,212
	%	%	%	%	%	%
Impairment allowances against customers as a percentage of loans and advances to customers:						
□ individually assessed	0.40	0.15	0.34	0.04	0.51	0.27
□ collectively assessed	0.46	0.27	0.56	3.93	3.48	1.65
At 31 December	0.86	0.42	0.90	3.97	3.99	1.92

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(Audited)

	2006					
	Europe US\$m	Hong Kong US\$m	Rest of Asia- Pacific US\$m	North America US\$m	Latin America US\$m	Total US\$m
Impairment allowances at 1 January	3,499	398	837	5,349	1,283	11,366
Amounts written off	(2,706)	(215)	(566)	(4,933)	(1,053)	(9,473)
Commercial, industrial and international trade	(454)	(56)	(79)	(97)	(96)	(782)
Real estate	(70)	(6)	(8)	(21)	(6)	(111)
Non-bank financial institutions	(20)	(7)	(11)	(1)	□	(39)
Other commercial	(116)	(3)	(7)	(31)	(103)	(260)
Residential mortgages	(2)	(3)	(7)	(595)	(21)	(628)
Other personal	(2,044)	(140)	(454)	(4,188)	(827)	(7,653)
Recoveries of amounts written off in previous years	421	41	95	85	137	779
Commercial, industrial and international trade	25	5	11	20	27	88
Real estate	15	□	3	3	□	21
Non-bank financial institutions	1	□	□	10	□	11
Other commercial	24	□	2	9	19	54
Residential mortgages	3	8	1	7	□	19
Other personal	353	28	78	36	91	586
Charge to income statement <sup>1</sup>	2,140	157	512	6,798	940	10,547
Banks	□	□	(1)	□	(2)	(3)
Commercial, industrial and international trade	246	40	(14)	107	124	503
Real estate	41	6	3	19	6	75
Non-bank financial institutions	(7)	□	(1)	(4)	6	(6)
Governments	(13)	□	□	(1)	(23)	(37)
Other commercial	23	(2)	(19)	18	66	86
Residential mortgages	24	4	□	1,039	29	1,096
Other personal	1,826	109	544	5,620	734	8,833
Foreign exchange and other movements	329	(16)	23	(52)	82	366
Impairment allowances at 31 December	3,683	365	901	7,247	1,389	13,585
Impairment allowances against banks:						
□ individually assessed	7	□	□	□	□	7
Impairment allowances against customers:						
□ individually assessed	1,725	131	362	109	238	2,565
□ collectively assessed	1,951	234	539	7,138	1,151	11,013
Impairment allowances at 31 December	3,683	365	901	7,247	1,389	13,585
	%	%	%	%	%	%
Impairment allowances against customers as a percentage of loans and						

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advances to customers:

□ individually assessed	0.44	0.15	0.46	0.04	0.64	0.29
□ collectively assessed	0.49	0.28	0.69	2.50	3.10	1.25
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
At 31 December	0.93	0.43	1.15	2.54	3.74	1.54
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>

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HSBC HOLDINGS PLC

**Report of the Directors: The Management of Risk** (continued)*Credit risk > Impairment allowances and charges / Provisions***Movement in impairment allowances by industry segment and by geographical region** (continued)  
(Audited)

	2005					
	Europe US\$m	Hong Kong US\$m	Rest of Asia- Pacific US\$m	North America US\$m	Latin America US\$m	Total US\$m
Impairment allowances at 1 January	4,851	504	960	5,231	1,088	12,634
Amounts written off	(2,804)	(294)	(329)	(4,913)	(703)	(9,043)
Commercial, industrial and international trade	(345)	(157)	(79)	(81)	(11)	(673)
Real estate	(67)	(23)	(11)	(14)	(2)	(117)
Non-bank financial institutions	(3)	□	□	(10)	□	(13)
Other commercial	(108)	□	(6)	(14)	(66)	(194)
Residential mortgages	(14)	(2)	(6)	(456)	(30)	(508)
Other personal	(2,267)	(112)	(227)	(4,338)	(594)	(7,538)
Recoveries of amounts written off in previous years	84	45	82	146	137	494
Commercial, industrial and international trade	10	4	17	37	8	76
Real estate	5	□	1	2	1	9
Other commercial	6	1	2	38	42	89
Residential mortgages	1	9	1	□	7	18
Other personal	62	31	61	69	79	302
Net charge/(release) to income statement <sup>1</sup>	1,984	146	136	4,919	675	7,860
Banks	(5)	□	(2)	□	□	(7)
Commercial, industrial and international trade	354	199	(72)	32	75	588
Real estate	59	□	1	(6)	2	56
Non-bank financial institutions	(14)	(1)	□	9	□	(6)
Governments	4	□	□	2	□	6
Other commercial	(21)	(32)	(1)	(18)	46	(26)
Residential mortgages	5	(25)	7	592	26	605
Other personal	1,602	5	203	4,308	526	6,644

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Foreign exchange and other movements	(616)	(3)	(12)	(34)	86	(579)
Impairment allowances at 31 December	3,499	398	837	5,349	1,283	11,366
Impairment allowances against banks:						
□ individually assessed	8	□	1	□	□	9
Impairment allowances against customers:						
□ individually assessed	1,575	173	500	221	214	2,683
□ collectively assessed	1,916	225	336	5,128	1,069	8,674
Impairment allowances at 31 December	3,499	398	837	5,349	1,283	11,366
	%	%	%	%	%	%
Impairment allowances against customers as a percentage of loans and advances to customers:						
□ individually assessed	0.50	0.21	0.71	0.09	0.93	0.36
□ collectively assessed	0.61	0.27	0.47	1.99	4.65	1.16
At 31 December	1.11	0.48	1.18	2.08	5.58	1.52

For footnotes, see page 234.

[Back to Contents](#)**Movement in provisions by industry segment and by geographical region***(Unaudited)*

	2004					
	Europe US\$m	Hong Kong US\$m	Rest of Asia- Pacific US\$m	North America US\$m	Latin America US\$m	Total US\$m
Provisions at 1 January	4,435	1,055	1,181	5,665	1,379	13,715
IFRSs transition adjustment at 1 January	(2)	(34)	(21)	□	(1)	(58)
Amounts written off	(1,331)	(302)	(403)	(6,125)	(683)	(8,844)
Commercial, industrial and international trade	(298)	(35)	(164)	(61)	(65)	(623)
Real estate	(30)	(55)	(17)	(3)	(1)	(106)
Non-bank financial institutions	(14)	(2)	(1)	(3)		(20)
Other commercial	(209)	(33)	(42)	(29)	(185)	(498)
Residential mortgages	(10)	(52)	(8)	(463)	(28)	(561)
Other personal	(770)	(125)	(171)	(5,566)	(404)	(7,036)
Recoveries of amounts written off in previous years	136	47	70	504	156	913
Commercial, industrial and international trade	27	10	4	38	39	118
Real estate	3	□	10	4	□	17
Non-bank financial institutions	3	□	□	□	□	3
Other commercial	5	3	14	18	45	85
Residential mortgages	1	12	1	8	9	31
Other personal	97	22	41	436	63	659
Net charge to profit and loss account <sup>3</sup>	1,023	(220)	102	5,018	272	6,195
Banks	(7)	□	(1)	□	(2)	(10)
Commercial, industrial and international trade	180	(56)	52	(9)	12	179
Real estate	21	(15)	(28)	(1)	1	(22)
Non-bank financial institutions	18	(3)	(1)	1	□	15
Governments	□	□	□	1	□	1
Other commercial	(65)	(29)	(18)	(21)	(35)	(168)
Residential mortgages	3	(14)	4	494	(5)	482
Other personal	1,035	120	142	4,616	303	6,216
General provisions	(162)	(223)	(48)	(63)	(2)	(498)
Foreign exchange and other movements	551	(24)	14	150	(53)	638
Provisions at 31 December	4,812	522	943	5,212	1,070	12,559
Provisions against banks:						
□ specific provisions	14	□	3	□	□	17
Provisions against customers:						
□ specific provisions	4,036	320	785	4,106	770	10,017
□ general provisions <sup>2</sup>	762	202	155	1,106	300	2,525
Provisions at 31 December	4,812	522	943	5,212	1,070	12,559

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	%	%	%	%	%	%
Provisions against customers as a percentage of loans and advances to customers						
□ specific provisions	1.43	0.40	1.27	1.67	4.58	1.46
□ general provisions	0.27	0.25	0.25	0.45	1.79	0.37
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
At 31 December	1.70	0.65	1.52	2.12	6.37	1.83
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>

*For footnotes, see page 234.*

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HSBC HOLDINGS PLC

**Report of the Directors: The Management of Risk** (continued)*Credit risk > Provisions / Loan impairment charge***Movement in provisions by industry segment and by geographical region** (continued)  
(Unaudited)

	2003					
	Europe US\$m	Hong Kong US\$m	Rest of Asia- Pacific US\$m	North America US\$m	Latin America US\$m	Total US\$m
Provisions at 1 January	3,668	1,143	1,496	642	2,191	9,140
Amounts written off	(902)	(584)	(445)	(4,469)	(1,056)	(7,456)
Commercial, industrial and international trade	(338)	(71)	(201)	(102)	(304)	(1,016)
Real estate	(31)	(12)	(18)	(3)	(115)	(179)
Non-bank financial institutions	(3)	(13)	(21)	□	(30)	(67)
Other commercial	(54)	(65)	(42)	(80)	(54)	(295)
Residential mortgages	(4)	(121)	(16)	(292)	(242)	(675)
Other personal	(472)	(302)	(147)	(3,992)	(311)	(5,224)
Recoveries of amounts written off in previous years	142	42	74	330	22	610
Commercial, industrial and international trade	25	16	18	20	3	82
Real estate	3	□	4	2	□	9
Non-bank financial institutions	2	□	5	4	□	11
Other commercial	49	4	11	10	7	81
Residential mortgages	1	6	1	2	3	13
Other personal	62	16	35	292	9	414
Net charge to profit and loss account <sup>3</sup>	874	400	85	4,557	177	6,093
Banks	(6)	□	3	□	□	(3)
Commercial, industrial and international trade	286	(3)	(45)	77	61	376
Real estate	15	(18)	(8)	(1)	1	(11)
Non-bank financial institutions	(1)	1	(17)	(5)	(1)	(23)
Governments	□	□	1	□	□	1
Other commercial	216	78	(4)	55	(6)	339
Residential mortgages	□	102	23	422	5	552
Other personal	482	271	116	3,950	164	4,983
General Provisions	(118)	(31)	16	59	(47)	(121)
Foreign exchange and other movements <sup>4</sup>	653	54	(29)	4,605	45	5,328
Provisions at 31 December	4,435	1,055	1,181	5,665	1,379	13,715

Provisions against banks:						
□ specific provisions	20	□	4	□	□	24
Provisions against customers:						
□ specific provisions	3,554	629	981	4,660	1,054	10,878
□ general provisions <sup>3</sup>	861	426	196	1,005	325	2,813
Provisions at 31 December	4,435	1,055	1,181	5,665	1,379	13,715
	%	%	%	%	%	%
Provisions against customers as a percentage of loans and advances to customers						
□ specific provisions	1.65	0.84	1.99	2.47	6.97	2.00
□ general provisions	0.40	0.57	0.40	0.53	2.15	0.52
At 31 December	2.05	1.41	2.39	3.00	9.12	2.52

1 See table below □Net impairment charge to income statement by geographical region□.

2 Collectively assessed impairment allowances (2004 and 2003: general provisions) are allocated to geographical segments based on the location of the office booking the provision. Consequently, the general provisions booked in Hong Kong may cover assets booked in branches located outside Hong Kong, principally in Rest of Asia-Pacific, as well as those booked in Hong Kong.

3 See table below □Net charge to the profit and loss account for bad and doubtful debts by geographical region□.

4 Other movements include amounts of US\$129 million in Europe and US\$4,524 million in North America transferred in on the acquisition of HSBC Finance Corporation, and of US\$116 million in Latin America transferred in on the acquisition of Lloyds TSB Group□s Brazilian businesses and assets.

[Back to Contents](#)**Net loan impairment charge to the income statement by geographical region***(Unaudited)***Year ended 31 December 2007**

	<b>Europe</b>	<b>Hong Kong</b>	<b>Rest of Asia-Pacific</b>	<b>North America</b>	<b>Latin America</b>	<b>Total</b>
	<b>US\$m</b>	<b>US\$m</b>	<b>US\$m</b>	<b>US\$m</b>	<b>US\$m</b>	<b>US\$m</b>
<b>Individually assessed impairment allowances</b>						
New allowances	781	103	211	228	210	1,533
Release of allowances no longer required	(388)	(32)	(96)	(54)	(38)	(608)
Recoveries of amounts previously written off	(38)	(14)	(32)	(26)	(19)	(129)
	<u>355</u>	<u>57</u>	<u>83</u>	<u>148</u>	<u>153</u>	<u>796</u>
<b>Collectively assessed impairment allowances</b>						
New allowances net of allowance releases	2,692	184	623	11,999	1,759	17,257
Recoveries of amounts previously written off	(504)	(29)	(92)	(36)	(215)	(876)
	<u>2,188</u>	<u>155</u>	<u>531</u>	<u>11,963</u>	<u>1,544</u>	<u>16,381</u>
Total charge for impairment losses	2,543	212	614	12,111	1,697	17,177
Banks	□	□	□	□	□	□
Customers	2,543	212	614	12,111	1,697	17,177
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
	%	%	%	%	%	%
Charge for impairment losses as a percentage of closing gross loans and advances	0.45	0.14	0.43	3.80	2.71	1.39
	<u>US\$m</u>	<u>US\$m</u>	<u>US\$m</u>	<u>US\$m</u>	<u>US\$m</u>	<u>US\$m</u>
<b>31 December 2007</b>						
Impaired loans	6,266	433	1,088	8,384	2,145	18,316
Impairment allowances	3,938	376	926	11,980	1,992	19,212

**Year ended 31 December 2006**

	<b>Europe</b>	<b>Hong Kong</b>	<b>Rest of Asia-Pacific</b>	<b>North America</b>	<b>Latin America</b>	<b>Total</b>
	<b>US\$m</b>	<b>US\$m</b>	<b>US\$m</b>	<b>US\$m</b>	<b>US\$m</b>	<b>US\$m</b>
<b>Individually assessed impairment allowances</b>						
New allowances	715	93	138	229	122	1,297
Release of allowances no longer required	(439)	(45)	(130)	(61)	(36)	(711)
Recoveries of amounts previously written off	(33)	(14)	(28)	(39)	(14)	(128)

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	243	34	(20)	129	72	458
Collectively assessed impairment allowances						
New allowances net of allowance releases	2,285	150	599	6,715	991	10,740
Recoveries of amounts previously written off	(388)	(27)	(67)	(46)	(123)	(651)
	1,897	123	532	6,669	868	10,089
Total charge for impairment losses	2,140	157	512	6,798	940	10,547
Banks	□	□	(1)	□	(2)	(3)
Customers	2,140	157	513	6,798	942	10,550
	%	%	%	%	%	%
Charge for impairment losses as a percentage of closing gross loans and advances	0.45	0.12	0.48	2.24	1.89	0.99
	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m
31 December 2006						
Impaired loans	5,858	454	1,188	4,822	1,478	13,800
Impairment allowances	3,683	365	901	7,247	1,389	13,585



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HSBC HOLDINGS PLC

**Report of the Directors: The Management of Risk** (continued)*Credit risk > Loan impairment charge > 2007***Net loan impairment charge to the income statement by geographical region** (continued)  
(Unaudited)

	Year ended 31 December 2005					Total US\$m
	Europe US\$m	Hong Kong US\$m	Rest of Asia- Pacific US\$m	North America US\$m	Latin America US\$m	
<b>Individually assessed impairment allowances</b>						
New allowances	1,029	200	131	299	56	1,715
Release of allowances no longer required	(648)	(123)	( 166)	(42)	( 19)	(998)
Recoveries of amounts previously written off	(21)	(18)	(34)	(101)	(25)	(199)
	<u>360</u>	<u>59</u>	<u>(69)</u>	<u>156</u>	<u>12</u>	<u>518</u>
<b>Collectively assessed impairment allowances</b>						
New allowances	2,013	159	339	5,072	842	8,425
Release of allowances no longer required	(326)	(45)	( 86)	(264)	( 67)	(788)
Recoveries of amounts previously written off	(63)	(27)	(48)	(45)	(112)	(295)
	<u>1,624</u>	<u>87</u>	<u>205</u>	<u>4,763</u>	<u>663</u>	<u>7,342</u>
<b>Total charge for impairment losses</b>	<b>1,984</b>	<b>146</b>	<b>136</b>	<b>4,919</b>	<b>675</b>	<b>7,860</b>
Banks	(5)	□	(2)	□	□	(7)
Customers	<u>1,989</u>	<u>146</u>	<u>138</u>	<u>4,919</u>	<u>675</u>	<u>7,867</u>
	%	%	%	%	%	%
<b>Charge for impairment losses as a percentage of closing gross loans and advances</b>	<b>0.55</b>	<b>0.12</b>	<b>0.15</b>	<b>1.83</b>	<b>2.11</b>	<b>0.90</b>
	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m
<b>31 December 2005</b>						
Impaired loans	5,081	506	945	3,710	1,226	11,468
Impairment allowances	3,499	398	837	5,349	1,283	11,366

**Net charge to the income statement for bad and doubtful debts by geographical region**  
(Unaudited)

Year ended 31 December 2004

	Europe	Hong Kong	Rest of Asia-Pacific	North America	Latin America	Total
	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m
Specific provisions						
New provisions	2,047	237	419	5,690	479	8,872
Release of provisions no longer required	(726)	(187)	(199)	(105)	(49)	(1,266)
Recoveries of amounts previously written off	(136)	(47)	(70)	(504)	(156)	(913)
	<u>1,185</u>	<u>3</u>	<u>150</u>	<u>5,081</u>	<u>274</u>	<u>6,693</u>
General provisions	(162)	(223)	(48)	( 63)	(2)	(498)
	<u>1,023</u>	<u>(220)</u>	<u>102</u>	<u>5,018</u>	<u>272</u>	<u>6,195</u>
Total bad and doubtful debt charge						
Banks	(7)	□	(1)	□	(2)	(10)
Customers	1,030	(220)	103	5,018	274	6,205
	<u>1,030</u>	<u>(220)</u>	<u>103</u>	<u>5,018</u>	<u>274</u>	<u>6,205</u>
	%	%	%	%	%	%
Bad and doubtful debt charge as a percentage of closing gross loans and advances	0.36	(0.28)	0.17	1.88	1.20	0.91
	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m
31 December 2004						
Non-performing loans	6,039	696	1,160	3,555	977	12,427
Provisions	4,798	522	940	5,212	1,070	12,542

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Year ended 31 December 2003

	Europe US\$m	Hong Kong US\$m	Rest of Asia-Pacific US\$m	North America US\$m	Latin America US\$m	Total US\$m
Specific provisions						
New provisions	1,485	655	412	4,907	318	7,777
Release of provisions no longer required	(351)	(182)	( 269)	(80)	( 71)	(953)
Recoveries of amounts previously written off	(142)	(42)	(74)	(329)	(23)	(610)
	992	431	69	4,498	224	6,214
General provisions	(118)	(31)	16	59	(47)	(121)
Total bad and doubtful debt charge	874	400	85	4,557	177	6,093
Banks	(6)	□	3	□	□	(3)
Customers	880	400	82	4,557	177	6,096
	%	%	%	%	%	%
Bad and doubtful debt charge as a percentage of closing gross loans and advances	0.41	0.53	0.17	2.33	0.79	1.12

	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m
31 December 2003						
Non-performing loans	5,701	1,671	1,538	4,889	1,251	15,050
Provisions	4,415	1,055	1,177	5,665	1,379	13,691

**Impairment allowances as a percentage of loans and advances to customers***(Unaudited)*

At 31 December

	2007 %	2006 %
<b>Total impairment allowances to gross lending<sup>1</sup></b>		
Individually assessed impairment allowances	<b>0.28</b>	0.30
Collectively assessed impairment allowances	<b>1.73</b>	1.28
	<b>2.01</b>	1.58

1 Net of reverse repo transactions, settlement accounts and stock borrowings.

Year ended 31 December 2007 compared with year ended 31 December 2006

*(Unaudited)*

Loan impairment charges rose by 63 per cent to US\$17.2 billion from US\$10.5 billion in 2006. The commentary that follows is on a constant currency basis:

New allowances for loan impairment charges rose by 52 per cent, compared with 2006. Releases and recoveries of allowances increased by 1 per cent to US\$1.6 billion.

In **Europe**, new loan impairment charges were US\$3.5 billion, a rise of 8 per cent compared with 2006. This partly reflected growth in commercial lending, where charges remained low compared with historical amounts but rose from the exceptionally low levels experienced in 2005 and 2006. Increased charges also reflected growth in credit card lending in Turkey. In the UK, refinements to the methodology used to calculate roll rate percentages resulted in a higher charge in the consumer finance

operations in the first half of the year. Excluding this, loan impairment charges were marginally lower than in 2006.

Releases and recoveries in Europe were broadly in line with 2006.

In **Hong Kong**, new loan impairment charges of US\$287 million were recorded, an increase of 19 per cent, due to the growth in credit card balances and new corporate loan charges.

Releases and recoveries in Hong Kong decreased to US\$75 million, primarily in the corporate sector. This reflected the low level of allowances added in recent years.

In **Rest of Asia-Pacific**, new loan impairment charges rose by 10 per cent to US\$834 million, with higher loan impairment charges arising in the commercial loan books in Thailand and Malaysia. This was offset by a decline in loan impairment charges for personal lending, particularly in Taiwan and Indonesia, where charges returned to more

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HSBC HOLDINGS PLC

## Report of the Directors: The Management of Risk (continued)

*Credit risk > Loan impairment charge > 2007 / 2006*

regular levels after an upsurge in 2006 due to regulatory changes which affected collection activity and minimum payments.

With corporate and commercial loan impairment charges low in recent years, releases and recoveries decreased by 6 per cent to US\$220 million.

New loan impairment charges in **North America** rose by 76 per cent to US\$12.2 billion, driven by the continued deterioration in credit quality in the US consumer finance loan portfolio.

US credit quality deteriorated as mortgage delinquencies rose, house prices declined, refinancing credit became less available in the market and the macroeconomic outlook worsened. The reasons behind the deterioration in US credit quality, the effects on the US personal lending portfolio and actions taken as a result are discussed in more detail on page 217.

Other factors affecting the rise in US loan impairment charges included normal seasoning of the portfolio, a higher proportion of unsecured personal lending and a return to historical norms from the unusually low levels of bankruptcy filings experienced in 2006, following changes enacted to US bankruptcy law in 2005.

Delinquency rates rose across all parts of the HSBC Finance personal lending portfolio, with mortgage services and consumer lending experiencing significant rises in delinquency which flowed through subsequent stages through to foreclosure. As the housing downturn began to have more effect on the broader economy, delinquency rates in credit cards and vehicle finance rose in the final quarter of 2007. A change in product mix in the cards portfolio towards higher yielding products also contributed to higher impairment charges as this segment of the portfolio seasoned.

Releases and recoveries in North America decreased to US\$116 million. In the US consumer finance business, collection staff increased in all lending portfolios as part of the response to the deteriorating credit environment.

In **Latin America**, new loan impairment charges rose by 63 per cent to US\$2.0 billion. The most significant increase was registered in Mexico, reflecting strong growth in balances, normal portfolio seasoning and a rise in delinquency rates in credit cards. Charges for commercial lending in Mexico fell as increased delinquency rates in the small and medium-sized business portfolios were offset by impairment allowance releases. Products with high credit losses were discontinued or restructured. Loan impairment charges in Brazil rose

marginally, due to growth in store loans and credit cards.

Releases and recoveries in Latin America increased to US\$272 million. In Brazil, credit models were changed during 2007 to align with credit behaviour in underlying portfolios.

Year ended 31 December 2006 compared with year ended 31 December 2005

*(Unaudited)*

Loan impairment charges increased by US\$2.7 billion, or 34 per cent, compared with 2005. Acquisitions accounted for US\$309 million of the rise, mainly Metris in the US. On an underlying basis, the increase was 30 per cent. Personal Financial Services continued to dominate loan impairments, representing 94 per cent of the

Group's charge. On a constant currency basis, the key trends were as follows.

New allowances for loan impairment charges of US\$12.0 billion increased by 27 per cent compared with 2005. Releases and recoveries of allowances were broadly in line with 2005.

In **Europe**, new loan impairment charges rose by 9 per cent compared with 2005 to US\$3.0 billion. A challenging credit environment in UK unsecured lending, which began to deteriorate in the middle of 2005, was the primary cause of the increase, although this was partly mitigated by continued benign corporate and commercial impairment experience. Personal bankruptcies and the use of IVAs have been on a rising trend since the introduction of legislation in 2004 that eased filing requirements, and this was further exacerbated by the recent active marketing of bankruptcy and IVA relief through the media by debt advisors. Additionally, a rise in unemployment, which began in the middle of 2005, and modest rises in interest rates added to the strain on some personal customers. In response, HSBC tightened underwriting controls in the second half of 2005, reduced its market share of unsecured personal lending and changed the product mix of new business towards lower-risk customers. In 2006, there were early signs of improvement in more recent unsecured lending. New loan impairment charges also rose in Turkey, by 30 per cent, mainly due to growth in unsecured credit card and personal lending as overall credit quality remained stable. In France, new charges fell, reflecting a stable credit environment and the reduction in charges following the sale of a consumer finance business in the second half of 2005.

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Releases and recoveries in Europe of US\$860 million were 17 per cent higher than in 2005. Increases in the UK were partially offset by a decline in France. In the UK, increased resources deployed on collection activities, combined with a rise in sales of delinquent debt, were reflected in significantly higher recoveries. The non-recurrence of several significant recoveries in 2005 led to a large fall in France.

In **Hong Kong**, new loan impairment charges declined by 22 per cent to US\$243 million, reflecting the non-recurrence of an individual charge in 2005 for a large commercial customer. This was partly offset by a rise in credit card impairments as a result of a rise in balances. Overall, credit quality remained stable as strong economic growth and low levels of unemployment continued.

Releases and recoveries fell by 49 per cent to US\$86 million, again mainly as a result of fewer individual impairment releases in the corporate and commercial sector and the non-recurrence of mortgage lending recoveries in 2005, following improvement in the property market since 2004.

In **Rest of Asia-Pacific**, there was an 88 per cent rise in new impairment allowances to US\$737 million. This was an improvement on the situation in the first half of 2006, when new impairment charges were 111 per cent higher than in the first half of 2005. The year-on-year increase was largely due to Taiwan and, to a lesser extent, Indonesia. During the first half of 2006, new government regulations placing restrictions on collection activity, combined with the popularity of renegotiation schemes offering the opportunity to waive interest and postpone principal payments, led to a sharp rise in credit card defaults, for which a full-year charge of US\$200 million was recorded. In the second half of 2006, this problem had begun to moderate and new impairment charges were 31 per cent lower than in the first half. In Indonesia, increased loan impairment charges in the personal sector reflected legislation which introduced higher minimum payment rules and a reduction in fuel subsidies. There were further rises in the Middle East, largely due to loan growth. Elsewhere in the region, credit quality was stable.

Releases and recoveries in the region fell by 11 per cent to US\$225 million. The fall was mainly in Malaysia and was partly offset by a rise in commercial releases and recoveries in the Middle East.

In **North America**, new loan impairment charges rose by 36 per cent. Excluding Metris, new charges increased by 30 per cent. Credit

deterioration, mainly in second lien, some portions of first lien and adjustable-rate mortgages acquired from third party correspondents through HSBC's mortgage services business, were the primary cause of the rise in new charges. As the housing market in the US slowed through 2006 and interest rates rose, delinquency trends on both second lien and portions of first lien mortgages originated in 2005 and 2006 were higher than for loans made in previous years. In addition, the extra payment obligations arising from the repricing of adjustable-rate mortgages to higher rates added to the assessed impairment of the correspondent portfolio, in particular in respect of second lien mortgages ranking behind adjustable-rate first lien mortgages.

As interest rate adjustments will be occurring in an environment of lower home value appreciation and tightening credit, it is estimated that the probability of default on adjustable-rate first mortgages subject to repricing, and on any second lien mortgage loans that are subordinate to an adjustable-rate first lien, will be greater than has been experienced in the past. As a result, loan impairment charges relating to the mortgage services portfolio have increased significantly.

In the second half of 2006, HSBC took action to tighten credit criteria in the mortgage services operation as detailed on page 217. As a consequence, balances in mortgage services declined compared with 30 June 2006.

Notwithstanding the credit weakness witnessed in the mortgage services business, credit delinquency in the majority of the other portfolios, including mortgage balances originated through the branch-based consumer lending business, rose modestly, driven by portfolio ageing and an increased proportion of credit card loans following the Metris acquisition. Partially offsetting factors included the effects of a decline in bankruptcy filings, especially in the first half of 2006 following the spike in the fourth quarter of 2005, low unemployment and the non-recurrence of charges relating to hurricane Katrina.

HSBC in the US closely monitors the two-month-and-over contractual delinquency ratio (being the ratio of two or more months delinquent accounts to gross loans and advances), as management views this as an important indicator of future write-offs. Details are disclosed below. The rise in the total ratio was chiefly as a result of the mortgage services business.

The increase in the US was partly offset by a small decline in new loan impairment charges in



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HSBC HOLDINGS PLC

**Report of the Directors: The Management of Risk** (continued)

*Credit risk > Loan impairment charge / HSBC Holdings / Risk elements*

Canada, as the strong economy continued to underpin good credit quality.

Releases and recoveries in North America decreased by 23 per cent to US\$146 million due to the non-recurrence of recoveries in the US.

In **Latin America**, new impairment charges rose by 24 per cent to US\$1.1 billion in 2006. This increase was chiefly attributable to Mexico and, to a lesser extent, Brazil. Strong growth in personal and

commercial lending in Mexico resulted in higher new charges. In Brazil, new charges rose by 11 per cent, a significant reduction from the 52 per cent rise reported in 2005, as credit quality improved following enhancements made to underwriting procedures during 2005 and 2006.

Latin American releases and recoveries went up by 7 per cent, largely in Mexico as a result of more stable political and economic conditions.

**Charge for impairment losses as a percentage of average gross loans and advances to customers**  
(Unaudited)

	Europe %	Hong Kong %	Rest of Asia-Pacific %	North America %	Latin America %	Total %
<b>Year ended 31 December 2007</b>						
New allowances net of allowance releases	<b>0.86</b>	<b>0.29</b>	<b>0.83</b>	<b>4.20</b>	<b>4.55</b>	<b>2.09</b>
Recoveries	<b>(0.15)</b>	<b>(0.05)</b>	<b>(0.14)</b>	<b>(0.02)</b>	<b>(0.55)</b>	<b>(0.12)</b>
Total charge for impairment losses	<b>0.71</b>	<b>0.24</b>	<b>0.69</b>	<b>4.18</b>	<b>4.00</b>	<b>1.97</b>
Amount written off net of recoveries	<b>0.67</b>	<b>0.23</b>	<b>0.67</b>	<b>2.55</b>	<b>2.95</b>	<b>1.36</b>
Year ended 31 December 2006	0.87	0.23	0.80	2.52	3.95	1.49

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New allowances net of allowance releases						
Recoveries	(0.14)	(0.05)	(0.13)	(0.03)	(0.50)	(0.10)
Total charge for impairment losses	0.73	0.18	0.67	2.49	3.45	1.39
Amount written off net of recoveries	0.77	0.20	0.62	1.77	3.36	1.15
Year ended 31 December 2005						
New allowances net of allowance releases	0.76	0.24	0.33	2.15	3.97	1.25
Recoveries	(0.03)	(0.06)	(0.13)	(0.07)	(0.68)	(0.09)
Total charge for impairment losses	0.73	0.18	0.20	2.08	3.29	1.16
Amount written off net of recoveries	1.00	0.31	0.37	2.02	2.77	1.26
Year ended 31 December 2004						
New provisions	0.78	0.31	0.77	2.61	3.09	1.41
Releases and recoveries	(0.33)	(0.30)	(0.49)	(0.28)	(1.32)	(0.35)
Net charge for specific provisions	0.45	0.01	0.28	2.33	1.77	1.06
Total provisions charged	0.39	(0.29)	0.19	2.31	1.64	0.99
Amount written off net of recoveries	0.46	0.33	0.61	2.57	3.41	1.26
Year ended 31 December 2003						
New provisions	0.76	0.89	0.96	3.06	2.22	1.60
Releases and recoveries	(0.25)	(0.30)	(0.80)	(0.25)	(0.65)	(0.32)
Net charge for specific provisions	0.51	0.59	0.16	2.81	1.57	1.28
Total provisions charged	0.45	0.54	0.20	2.84	1.23	1.25
Amount written off net of recoveries	0.39	0.73	0.86	2.58	7.20	1.40

HSBC Holdings  
(Audited)

Credit risk arises in HSBC Holdings primarily as a result of transactions with Group subsidiaries as well as guarantees issued in support of obligations incurred by some Group businesses in the normal conduct of their business.

These risks are reviewed and managed, within regulatory and internal limits for exposures, by the HSBC Group Risk function, which provides high-level, centralised oversight and management of HSBC's credit risks world-wide, reporting to the Group Chief Risk Officer.

No collateral or other credit enhancements were held by HSBC Holdings in respect of its transactions with subsidiary undertakings.



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HSBC Holdings' maximum exposure to credit risk at 31 December 2007 is shown below. HSBC Holdings' financial assets represent claims on Group

subsidiaries, principally located in Europe and North America.

	2007			2006 (restated ) <sup>1</sup>		
	Carrying value US\$m	Off-balance sheet exposure US\$m	Maximum exposure US\$m	Carrying value US\$m	Off-balance sheet exposure US\$m	Maximum exposure US\$m
Derivatives	2,660	□	2,660	1,599	□	1,599
Loans and advances to HSBC undertakings	17,242	3,638	20,880	14,456	3,967	18,423
Financial investments	3,022	□	3,022	3,614	□	3,614
Guarantees	□	38,457	38,457	□	17,605	17,605
	<b>22,924</b>	<b>42,095</b>	<b>65,019</b>	19,669	21,572	41,241

1 Comparative figures have been restated to include US\$298 million of available-for-sale assets within the total for financial investments held by HSBC Holdings.

All of the derivative transactions are with HSBC undertakings which are banking counterparties (2006: 100 per cent).

The credit quality of loans and advances to HSBC undertakings is assessed as satisfactory risk, with 100 per cent of the exposure being neither past due nor impaired (2006: 100 per cent).

The long-term debt rating of issuers of financial investments is within the Standard & Poor's ratings range of AA to AA+ (2006: AA to AA+).

Risk elements in the loan portfolio  
(This section all unaudited)

The disclosure of credit risk elements under the following headings reflects US accounting practice and classifications for publicly traded bank holding companies:

- loans accounted for on a non-accrual basis;
- accruing loans contractually past due 90 days or more as to interest or principal; and
- troubled debt restructurings not included in the above.

Troubled debt restructurings

The SEC requires separate disclosure of any loans whose terms have been modified because of problems with the borrower to grant concessions other than are warranted by market conditions. These are classified as 'troubled debt restructurings' and are distinct from the normal restructure activities in personal loan portfolios described in 'Renegotiated loans' on page 227. Disclosure of troubled debt restructurings may be discontinued after the first year if the debt performs in accordance with the new terms.

Troubled debt restructurings increased by 54 per cent in 2007, reflecting measures taken to mitigate risk in the US consumer finance business in response to the deterioration in mortgage loans.

#### Unimpaired loans past due 90 days or more

Unimpaired loans contractually past due 90 days or more increased by 11 per cent. The rise was largely attributable to the US consumer finance business, where credit quality deteriorated throughout the year. The rise in overdue balances on credit cards in Mexico also contributed.

#### Impaired loans

In accordance with IFRSs, HSBC recognises interest income on assets after they have been written down as a result of an impairment loss. In the following tables, HSBC represents information on its impaired loans and advances which are designated in accordance with the policy described above.

#### Potential problem loans

Credit risk elements also cover potential problem loans. These are loans where information on possible credit problems among borrowers causes management to seriously doubt their ability to comply with the loan repayment terms. There are no potential problem loans other than those identified in the table of risk elements set out below, and as discussed in "Areas of special interest" above, including ARMs and stated-income products.

#### Risk elements

The following table provides an analysis of risk elements in the loan portfolios at 31 December for the past five years:

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**Report of the Directors: The Management of Risk** (continued)*Credit risk > Risk elements / Liquidity and funding > Policies / Primary sources of funding*

	At 31 December				
	2007 US\$m	2006 US\$m	2005 US\$m	2004 US\$m	2003 US\$m
<b>Impaired loans</b>					
Europe	6,266	5,858	5,081	6,053	5,680
Hong Kong	433	454	506	696	1,670
Rest of Asia-Pacific	1,088	1,188	945	1,172	1,519
North America	8,384	4,822	3,710	3,600	4,177
Latin America	2,145	1,478	1,226	932	1,170
	<b>18,316</b>	13,800	11,468	12,453	14,216
<b>Troubled debt restructurings</b>					
Europe	648	360	239	213	335
Hong Kong	146	189	198	436	571
Rest of Asia-Pacific	34	73	121	56	68
North America	3,322	1,712	1,417	1,600	1,569
Latin America	848	915	878	830	1,041
	<b>4,998</b>	3,249	2,853	3,135	3,584
<b>Unimpaired loans contractually past due 90 days or more as to principal or interest</b>					
Europe	202	237	592	68	34
Hong Kong	49	79	74	67	205
Rest of Asia-Pacific	156	78	40	56	45
North America	1,302	1,364	924	1,171	1,252
Latin America	421	165	4	□	2
	<b>2,130</b>	1,923	1,634	1,362	1,538
<b>Trading loans classified as grades 6 and 7</b>					
North America	675	127	11	□	□
<b>Risk elements on loans</b>					
Europe	7,116	6,455	5,912	6,334	6,049
Hong Kong	628	722	778	1,199	2,446
Rest of Asia-Pacific	1,278	1,339	1,106	1,284	1,632
North America	13,683	8,025	6,062	6,371	6,998
Latin America	3,414	2,558	2,108	1,762	2,213
	<b>26,119</b>	19,099	15,966	16,950	19,338

<b>Assets held for resale</b>					
Europe	59	30	205	27	32
Hong Kong	29	42	49	75	2
Rest of Asia-Pacific	7	17	31	21	30
North America	1,172	999	582	664	720
Latin America	101	91	103	44	74
	<b>1,368</b>	1,179	970	831	858
<b>Total risk elements</b>					
Europe	7,175	6,485	6,117	6,361	6,081
Hong Kong	657	764	827	1,274	2,448
Rest of Asia-Pacific	1,285	1,356	1,137	1,305	1,662
North America	14,855	9,024	6,644	7,035	7,718
Latin America	3,515	2,649	2,211	1,806	2,287
	<b>27,487</b>	20,278	16,936	17,781	20,196
	%	%	%	%	%
Loan impairment allowances as a percentage of risk elements on loans <sup>1</sup>	75.5	71.6	71.2	74.1	70.9

1 Ratio excludes trading loans classified as grades 6 and 7.

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## **Liquidity and funding management**

*(Audited)*

Liquidity risk is the risk that HSBC does not have sufficient financial resources to meet its obligations as they fall due, or will have to do so at an excessive cost. This risk arises from mismatches in the timing of cash flows. Funding risk (a form of liquidity risk) arises when the necessary liquidity to fund illiquid asset positions cannot be obtained at the expected terms and when required.

The objective of HSBC's liquidity and funding management is to ensure that all foreseeable funding commitments, including deposit withdrawals, can be met when due, and that access to the wholesale markets is co-ordinated and cost-effective. It is HSBC's objective to maintain a diversified and stable funding base comprising core retail and corporate customer deposits and institutional balances. This is augmented by wholesale funding and maintaining portfolios of highly liquid assets which are diversified by currency and maturity, with the objective of enabling HSBC to respond quickly and smoothly to unforeseen liquidity requirements.

HSBC requires its operating entities to maintain a strong liquidity position and to manage the liquidity profile of their assets, liabilities and commitments with the objective of ensuring that cash flows are appropriately balanced and all obligations can be met when due.

### **Policies and procedures**

*(Audited)*

The management of liquidity and funding is primarily carried out locally in the operating entities of HSBC in accordance with practices and limits set by the Group Management Board. These limits vary by entity to take account of the depth and liquidity of the market in which the entity operates. It is HSBC's general policy that each banking entity should be self-sufficient with regards to funding its own operations. Exceptions are permitted to facilitate the efficient funding of certain short-term treasury requirements and start-up operations or branches which do not have access to local deposit markets, all of which are funded under clearly defined internal and regulatory guidelines and limits from HSBC's largest banking operations. These internal and regulatory limits and guidelines serve to place formal limitations on the transfer of resources between HSBC entities and are necessary to reflect the broad range of currencies, markets and time zones within which HSBC operates.

The Group's liquidity and funding management process includes:

- projecting cash flows by major currency under various stress scenarios and considering the level of liquid assets necessary in relation thereto;
- monitoring balance sheet liquidity ratios against internal and regulatory requirements;
- maintaining a diverse range of funding sources with adequate back-up facilities;
- managing the concentration and profile of debt maturities;
- managing contingent liquidity commitment exposures within pre-determined caps;



- maintaining debt financing plans;
- monitoring depositor concentration in order to avoid undue reliance on large individual depositors and ensuring a satisfactory overall funding mix; and
- maintaining liquidity and funding contingency plans. These plans identify early indicators of stress conditions and describe actions to be taken in the event of difficulties arising from systemic or other crises, while minimising adverse long-term implications for the business.

Primary sources of funding

*(Audited)*

Current accounts and savings deposits payable on demand or at short notice form a significant part of HSBC's funding. HSBC places considerable importance on maintaining the stability of these deposits.

The stability of deposits, which are a primary source of funding, depends upon preserving depositor confidence in HSBC's capital strength and liquidity, and on competitive and transparent deposit-pricing strategies.

HSBC also accesses professional markets in order to provide funding for non-banking subsidiaries that do not accept deposits, to maintain a presence in local money markets and to optimise the funding of asset maturities not naturally matched by core deposit funding. In aggregate, HSBC's banking entities are liquidity providers to the inter-bank market, placing significantly more funds with other banks than they themselves borrow.

The main operating subsidiary that does not accept deposits is HSBC Finance, which funds itself principally by taking term funding in the professional markets and by securitising assets.

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**Report of the Directors: The Management of Risk** (continued)*Liquidity and funding > Primary sources of funding*

At 31 December 2007, US\$142 billion (2006: US\$150 billion) of HSBC Finance's liabilities were drawn from professional markets, utilising a

range of products, maturities and currencies to avoid undue reliance on any particular funding source.

**Cash flows payable by HSBC under financial liabilities by remaining contractual maturities**  
(Audited)

	On demand US\$m	Due within 3 months US\$m	Due between 3 and 12 months US\$m	Due between 1 and 5 years US\$m	Due after 5 years US\$m
<b>At 31 December 2007</b>					
Deposits by banks	42,793	78,429	11,445	4,208	5,199
Customer accounts	629,227	391,659	56,294	29,445	6,614
Trading liabilities	314,580				
Financial liabilities designated at fair value	11,730	2,083	8,286	43,147	68,726
Derivatives	181,009	113	873	1,663	613
Debt securities in issue	635	90,718	59,626	109,054	38,782
Subordinated liabilities	3	277	1,951	10,181	34,841
Other financial liabilities	20,516	29,812	5,177	977	1,273
	<b>1,200,493</b>	<b>593,091</b>	<b>143,652</b>	<b>198,675</b>	<b>156,048</b>
Loan commitments	312,146	155,142	155,565	113,072	28,532
	<b>1,512,639</b>	<b>748,233</b>	<b>299,217</b>	<b>311,747</b>	<b>184,580</b>
<b>At 31 December 2006</b>					
Deposits by banks	29,609	55,239	8,462	6,356	4,893
Customer accounts	535,695	301,847	47,560	25,155	5,420
Trading liabilities	226,608				
Financial liabilities designated at fair value	8,990	1,103	2,855	36,194	52,222
Derivatives	99,790	671	884	1,337	167
Debt securities in issue	919	80,288	38,831	102,069	51,171
Subordinated liabilities		285	1,296	11,221	30,764
Other financial liabilities	14,809	34,838	1,094	206	711
	916,420	474,271	100,982	182,538	145,348
Loan commitments	321,075	144,382	125,141	89,306	34,726

1,237,495	618,653	226,123	271,844	180,074
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The balances in the above table will not agree directly to the balances in the consolidated balance sheet as the table incorporates all cash flows, on an undiscounted basis, relating to both principal and those associated with all future coupon payments (except for trading liabilities and trading derivatives). Furthermore, loan commitments are generally not recognised on the balance sheet. Trading liabilities and trading derivatives have been included in the "On demand" time bucket, and not by contractual maturity, because trading liabilities are typically held for short periods of time. The undiscounted cash flows on hedging derivative liabilities are classified according to their contractual maturity.

Cash flows payable in respect of customer accounts are primarily contractually repayable on demand or at short notice. However, in practice, short-term deposit balances remain stable as inflows and outflows broadly match.

#### Advances to deposits ratio

*(Audited)*

HSBC emphasises the importance of current accounts and savings accounts as a source of funds to finance lending to customers, and discourages reliance on short-term professional funding. To achieve this goal, limits are placed on Group banking entities which restrict their ability to grow loans to customers without corresponding growth in core current accounts and savings accounts. This measure is referred to as the "advances to deposits" ratio.

Advances to deposits ratio limits are set by the RMM and monitored by Group Finance. The ratio compares loans and advances to customers as a percentage of core customer current and savings accounts together with term funding with a remaining term to maturity in excess of one year. Loans to customers which are part of reverse repurchase arrangements, and where the Group

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receives securities which are deemed to be liquid, are excluded from the advances to deposits ratio. Current accounts and savings accounts from customers deemed to be "professional" are excluded. The definition of a professional customer takes account of the size of the customer's total deposit balances by applying a tiering classification. Generally, any customer with total funds deposited in excess of US\$2 million is regarded as professional. Due to the distinction between core and professional depositors, the Group's measure of advances to deposits will be more restrictive than that which could be inferred from the published financial statements.

### The advances to deposits ratios of the Group's principal banking entities

(Audited)

	Year ended 31 December	
	2007 %	2006 %
HSBC Bank (UK operations)		
Year-end	97.5	100.7
Maximum	101.7	104.3
Minimum	92.6	98.1
Average	97.1	102.0
The Hongkong and Shanghai Banking Corporation		
Year-end	76.7	72.4
Maximum	82.2	77.8
Minimum	72.4	72.4
Average	76.4	75.5
HSBC Bank USA		
Year-end	114.9	116.8
Maximum	116.8	132.3
Minimum	107.0	115.8
Average	112.7	121.4
Total of Group's other principal banking entities		
Year-end	88.4	87.5
Maximum	89.3	91.6
Minimum	86.2	87.5
Average	87.7	88.8

The three major Group banking entities shown

separately in the table above represented 71 per cent of the Group's total core deposits at 31 December 2007 (2006: 73 per cent). The table demonstrates that loans to customers in the Group's principal banking entities are broadly financed by reliable and stable sources of funding.

HSBC would meet any unexpected net cash outflows by selling securities and accessing additional funding sources such as interbank or collateralised lending markets. In addition to the advances to deposits ratio, the Group uses a range of other measures for managing liquidity risk. These other measures include the ratio of net liquid assets to customer liabilities and projected cash flow scenario analyses.

### Ratio of net liquid assets to customer liabilities

(Audited)

Net liquid assets are liquid assets less all funds maturing in the next 30 days from wholesale market sources and from customers who are deemed to be professional. The Group defines liquid assets for the purposes of the liquidity ratio as cash balances, short-term interbank deposits and highly rated debt securities available for immediate sale and for which a deep and liquid market exists. As noted above, the definition of a professional

customer takes account of the size of the customer's total deposits. Contingent liquidity risk associated with committed loan facilities is not reflected in the ratios. The Group's framework for monitoring this risk is outlined below.

Limits for the ratio of net liquid assets to customer liabilities are set for each bank operating entity. As HSBC Finance does not accept customer deposits, it is not appropriate to manage their liquidity using the standard liquidity ratios. The liquidity and funding risk framework of HSBC Finance is discussed below.

Ratios of net liquid assets to customer liabilities are provided in the following table. For additional information, the US dollar equivalents of net liquid assets are also provided.

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**Report of the Directors: The Management of Risk** (continued)*Liquidity and funding > Primary sources of funding / HSBC Holdings***Ratio of net liquid assets to customer liabilities and net liquid assets**  
(Audited)

	Year ended 31 December 2007		Year ended 31 December 2006	
	Ratio %	Net liquid assets US\$bn	Ratio %	Net liquid assets US\$bn
HSBC Bank (UK operations)				
Year-end	12.1	44.2	16.3	48.7
Maximum	21.5	80.6	19.1	50.1
Minimum	12.1	39.9	12.8	32.9
Average	15.6	52.4	15.1	40.1
The Hongkong and Shanghai Banking Corporation				
Year-end	21.8	53.9	21.4	46.7
Maximum	24.1	56.9	21.4	46.7
Minimum	16.1	35.3	14.2	28.4
Average	20.8	48.2	17.5	36.1
HSBC Bank USA				
Year-end	15.8	17.1	22.7	22.5
Maximum	25.7	26.1	25.5	25.5
Minimum	15.8	17.1	19.1	17.8
Average	21.3	22.0	23.7	23.1
Total of Group's other principal banking entities				
Year-end	21.0	66.1	24.5	59.4
Maximum	26.1	72.7	25.6	61.3
Minimum	21.0	58.8	20.8	43.9
Average	24.0	65.3	22.9	51.7

The "Total of Group's other principal banking entities" reflects the other main banking subsidiaries and, as such, includes businesses spread across a range of locations, in many of which the Group may require a higher ratio of net liquid assets to customer liabilities to reflect local market conditions.

Projected cash flow scenario analysis

*(Audited)*

The Group uses a number of standard projected cash flow scenarios which are designed to model both Group-specific and market-wide liquidity crises. The scenarios vary the rate and timing of deposit withdrawals and drawdowns on committed lending facilities, and restrict access to interbank funding, term debt markets and the ability to generate funds from asset portfolios. The scenarios are modelled by all Group banking entities and by HSBC Finance. The assumptions for each scenario are regularly reviewed for appropriateness. In addition to the Group's standard projected cash flow scenarios, individual entities are required to design their own scenarios tailored to reflect specific local market conditions, products and funding bases.

Limits for cumulative net cash flows under stress scenarios are set for each banking entity and for HSBC Finance.

Both ratio and cash flow limits reflect the local market place, the diversity of funding sources available and the concentration risk from large depositors. Compliance with entity level limits is monitored centrally by Group Finance and reported regularly to the RMM.

### **HSBC Finance**

As HSBC Finance does not accept customer deposits, it takes funding from the professional markets. HSBC Finance uses a range of measures to monitor funding risk, including projected cash flow scenario analysis and placing caps on the amount of unsecured term funding that can mature in any rolling three-month and rolling 12-month periods. HSBC Finance also maintains access to committed sources of secured funding and has in place committed backstop lines for short-term refinancing CP programmes. At 31 December 2007, the maximum amounts of unsecured term funding maturing in any rolling three-month and rolling 12-month periods were US\$6.2 billion and US\$17.7 billion, respectively (2006: US\$6.1 billion and US\$16.0 billion). At 31 December 2007, HSBC Finance also had in place unused committed sources of secured funding, for which eligible assets were held, of US\$6.2 billion (2006: US\$9.0 billion) and committed backstop lines from non-Group entities in support of CP programmes totalling US\$9.3 billion (2006: US\$9.3 billion).

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The deterioration of the US sub-prime credit market has reduced the willingness of financial institutions to provide committed financing to entities with exposures to the US sub-prime market, such as HSBC Finance. HSBC Finance continues to have access to term funding markets, although the price of this funding has increased to reflect the downturn in credit markets. Funding plans are in place to enable HSBC Finance to deal with continued stress in the credit markets.

#### Contingent liquidity risk (Audited)

In the normal course of its business, the Group provides committed facilities to customers; these

facilities include committed backstop lines to conduit vehicles sponsored by the Group. The liquidity risk consequences of drawdowns on these committed loan facilities provided by Group entities are reflected in projected cash flow scenario analyses, in which the level of drawdown is varied under different stress scenarios. The Group also sets total notional limits by Group entity for non-cancellable contingent funding commitments. The limits are set by the RMM after due consideration of the entity's ability to fund the commitments. The limits are split according to the borrower, the liquidity of the underlying assets and the size of the committed line.

#### The Group's contractual exposures as at 31 December monitored under the contingent liquidity risk limit structure

(Audited)

	HSBC Bank		HSBC Bank USA		HSBC Bank Canada		The Hongkong and Shanghai Banking Corporation	
	2007	2006	2007	2006	2007	2006	2007	2006
	US\$bn	US\$bn	US\$bn	US\$bn	US\$bn	US\$bn	US\$bn	US\$bn
<b>Conduits</b>								
Client-originated assets <sup>1</sup>								
□ total lines	<b>9.0</b>	6.0	<b>9.7</b>	9.0	□	□	□	□
□ largest individual lines	<b>1.6</b>	1.5	<b>0.9</b>	1.0	□	□	□	□
HSBC-managed assets <sup>2</sup>	<b>25.7</b>	25.8	□	□	□	□	□	□
Other conduits	□	□	<b>2.6</b>	3.3	<b>2.5</b>	2.2	□	□
<b>Single-issuer liquidity facilities</b>								
□ five largest	<b>10.0</b>	10.9	<b>5.9</b>	4.2	□	□	<b>1.3</b>	1.3
□ largest market sector	<b>11.7</b>	9.5	<b>4.2</b>	5.2	□	□	<b>2.3</b>	2.8

- 1 These vehicles provide funding to Group customers by issuing debt secured by a diversified pool of customer-originated assets.
- 2 These vehicles issue debt secured by highly rated asset-backed securities which are managed by HSBC. All of the exposures shown in the table under this category related to Solitaire.
- 3 These figures represent the five largest committed liquidity facilities provided to customers other than those facilities to conduits.
- 4 These figures represent the total of all committed liquidity facilities provided to the largest market sector.



The Group recognises that, in times of market stress, it may choose to provide non-contractual liquidity support to certain HSBC-sponsored vehicles or HSBC-promoted products. Such potential support would not be included in the Group's liquidity risk measures until such time as the support becomes legally binding, and would only be provided after careful consideration of the potential funding requirement and the impact on the entity's overall levels of liquidity.

In the second half of 2007, HSBC provided additional funding to two SIVs sponsored by the Group (Cullinan and Asscher) in the form of repos, CP purchases and the acquisition of assets at fair value from Cullinan. In November 2007, HSBC announced its intention to provide investors in Cullinan and Asscher with the option to exchange their capital notes for notes issued by one or more new SPEs, with term funding and liquidity to be

provided by HSBC. For further information on these SIVs, see "Off-balance sheet arrangements and special purpose entities" on page 183.

HSBC Holdings  
*(Audited)*

HSBC Holdings' primary sources of cash are interest and capital receipts from its subsidiaries, which it deploys in short-term bank deposits or liquidity funds. HSBC Holdings' primary uses of cash are investments in subsidiaries, interest payments to debt holders and dividend payments to shareholders. On an ongoing basis, HSBC Holdings replenishes its liquid resources through the receipt of interest on, and repayment of, intra-group loans, from dividends paid by subsidiaries and from interest earned on its own liquid funds. The ability of its subsidiaries to pay dividends or advance monies to HSBC Holdings depends, among other things, on their respective

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HSBC HOLDINGS PLC

**Report of the Directors: The Management of Risk** (continued)

*Liquidity and funding > HSBC Holdings / Market risk management > VAR*

regulatory capital requirements, statutory reserves, and financial and operating performance.

HSBC actively manages the cash flows from its subsidiaries to optimise the amount of cash held at the holding company level, and expects to continue doing so in the future. The wide range of HSBC's activities means that HSBC Holdings is not dependent on a single source of profits to fund its dividends. HSBC Holdings is also subject to contingent liquidity risk by virtue of loan

commitments and guarantees given. Such commitments are only provided after due consideration of HSBC Holdings' ability to finance these commitments and the likelihood of the need arising. Together with its accumulated liquid assets, HSBC Holdings believes that planned dividends and interest from subsidiaries will enable it to meet anticipated cash obligations. Also, in usual circumstances, HSBC Holdings has full access to capital markets on normal terms.

**Cash flows payable by HSBC Holdings under financial liabilities by remaining contractual maturities**  
(Audited)

	On demand US\$m	Due within 3 months US\$m	Due between 3 and 12 months US\$m	Due between 1 and 5 years US\$m	Due after 5 years US\$m
<b>At 31 December 2007</b>					
Amounts owed to HSBC undertakings	□	109	1,801	1,192	□
Financial liabilities designated at fair value	□	258	776	8,152	28,639
Derivatives	44	□	□	□	□
Subordinated liabilities	□	160	482	2,568	23,069
Other financial liabilities	□	1,398	□	□	□
	<b>44</b>	<b>1,925</b>	<b>3,059</b>	<b>11,912</b>	<b>51,708</b>
Loan commitments	3,638	□	□	□	□
	<b>3,682</b>	<b>1,925</b>	<b>3,059</b>	<b>11,912</b>	<b>51,708</b>
<b>At 31 December 2006</b>					
Amounts owed to HSBC undertakings	109	221	88	3,025	5
Financial liabilities designated at fair value	□	177	532	4,039	21,029
Derivatives	177	□	□	□	□
Subordinated liabilities	□	158	473	2,525	23,327
Other financial liabilities	13	1,608	□	□	8

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	299	2,164	1,093	9,589	44,369
Loan commitments	3,967	□	□	□	□
	<u>4,266</u>	<u>2,164</u>	<u>1,093</u>	<u>9,589</u>	<u>44,369</u>

At 31 December 2007, the short-term liabilities of HSBC Holdings totalled US\$3.3 billion (2006: US\$1.8 billion), including US\$1.4 billion in respect of the third interim dividend for 2007 (2006: US\$1.5 billion) which was paid on 16 January 2008. Short-term assets of US\$8.1 billion (2006: US\$7.6 billion) consisted mainly of cash at bank of US\$360 million (2006: US\$729 million) and loans and advances to HSBC undertakings of US\$7.4 billion (2006: US\$6.9 billion). Derivatives have been included in the □On demand□ time bucket, and not by contractual maturity. The undiscounted cash flows on hedging derivative liabilities are classified according to their contractual maturity.

Market risk management

*(Audited)*

The objective of HSBC's market risk management is to manage and control market risk exposures in order to optimise return on risk while maintaining a market profile consistent with the Group's status as one of the world's largest banking and financial services organisations.

Market risk is the risk that movements in market risk factors, including foreign exchange rates and commodity prices, interest rates, credit spreads and equity prices will reduce HSBC's income or the value of its portfolios.

HSBC separates exposures to market risk into trading and non-trading portfolios. Trading portfolios include those positions arising from market-making, proprietary position-taking and other marked-to-market positions so designated.

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Non-trading portfolios include positions that arise from the interest rate management of HSBC's retail and commercial banking assets and liabilities, financial investments designated as available for sale and held to maturity, and exposures arising from HSBC's insurance operations.

Market risk arising in HSBC's insurance businesses is discussed in "Risk management of insurance operations" on pages 272 to 275.

The management of market risk is principally undertaken in Global Markets using risk limits approved by the Group Management Board. Limits are set for portfolios, products and risk types, with market liquidity being a principal factor in determining the level of limits set. Traded Credit and Market Risk, an independent unit within the Group Management Office, develops the Group's market risk management policies and measurement techniques. Each major operating entity has an independent market risk management and control function which is responsible for measuring market risk exposures in accordance with the policies defined by Traded Credit and Market Risk, and monitoring and reporting these exposures against the prescribed limits on a daily basis.

Each operating entity is required to assess the market risks which arise on each product in its business and to transfer these risks to either its local Global Markets unit for management, or to separate books managed under the supervision of the local Asset and Liability Management Committee ("ALCO"). The aim is to ensure that all market risks are consolidated within operations which have the necessary skills, tools, management and governance to manage such risks professionally. In certain cases where the market risks cannot be adequately captured by the transfer process, simulation modelling is used to identify the impact of varying scenarios on valuations and net interest income.

HSBC uses a range of tools to monitor and limit market risk exposures. These include value at risk ("VAR"), sensitivity analysis and stress testing. The following table provides an overview of the reporting of risks within this section:

Risk type	Portfolio	
	Trading	Non-trading
Foreign exchange	VAR	VAR <sub>1</sub>
Interest rate	VAR	VAR <sub>2</sub>
Commodity	VAR	N/A
Equity	VAR	Sensitivity
Credit spread	Sensitivity	Sensitivity <sub>3</sub>

1 The structural foreign exchange risk is not included within VAR. This is discussed on page 256.

2 The VAR for the fixed-rate securities issued by HSBC Holdings is not included within the Group VAR. This is disclosed separately on page 252.

3 Credit spread VAR is reported for the credit derivatives transacted by Global Banking. This is disclosed on page 251.

Value at risk  
(Audited)

VAR is a technique that estimates the potential losses that could occur on risk positions as a result of movements in market rates and prices over a specified time horizon and to a given level of confidence.

The VAR models used by HSBC are predominantly based on historical simulation. These models derive plausible future scenarios from past series of recorded market rates and prices, taking account of inter-relationships between different markets and rates such as interest rates and foreign exchange rates. The models also incorporate the effect of option features on the underlying exposures.

The historical simulation models used by HSBC incorporate the following features:

- potential market movements are calculated with reference to data from the past two years;
-

historical market rates and prices are calculated with reference to foreign exchange rates and commodity prices, interest rates, equity prices and the associated volatilities;

- VAR is calculated to a 99 per cent confidence level; and

- VAR is calculated for a one-day holding period.

HSBC routinely validates the accuracy of its VAR models by backtesting the actual daily profit and loss results, adjusted to remove non-modelled items such as fees and commissions, against the corresponding VAR numbers. Statistically, HSBC would expect to see losses in excess of VAR only 1 per cent of the time over a one-year period. The actual number of excesses over this period can therefore be used to gauge how well the models are performing.

Although a valuable guide to risk, VAR should always be viewed in the context of its limitations. For example:

- the use of historical data as a proxy for estimating future events may not encompass all potential events, particularly those which are extreme in nature;
- the use of a one-day holding period assumes that all positions can be liquidated or hedged in one

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**Report of the Directors: The Management of Risk** (continued)**Market risk > VAR / Trading portfolios**

- day. This may not fully reflect the market risk arising at times of severe illiquidity, when a one-day holding period may be insufficient to liquidate or hedge all positions fully;
- the use of a 99 per cent confidence level, by definition, does not take into account losses that might occur beyond this level of confidence;
- VAR is calculated on the basis of exposures outstanding at the close of business and therefore does not necessarily reflect intra-day exposures; and
- VAR is unlikely to reflect loss potential on exposures that only arise under significant market moves.

HSBC recognises these limitations by augmenting its VAR limits with other position and sensitivity limit structures. HSBC also applies a wide range of stress testing, both on individual portfolios and on the Group's consolidated positions.

The VAR, both trading and non-trading, for the Group was as follows:

**Value at risk***(Audited)*

	<b>2007</b>	2006 <sup>1</sup>
	<b>US\$m</b>	US\$m
At 31 December	<b>95.3</b>	68.9
Average	<b>78.4</b>	74.5
Minimum	<b>55.6</b>	41.5
Maximum	<b>107.0</b>	128.8

<sup>1</sup> Restated to incorporate the VAR for HSBC Finance and mortgage servicing rights that were previously reported separately.

Total VAR at 31 December 2007 increased, compared with 31 December 2006. The major cause of this was an increase in volatility in market rates during the latter half of 2007.

The daily VAR, both trading and non-trading, for the Group was as follows:

**Daily VAR (trading and non-trading) (US\$m)***(Unaudited)*

The major contributor to the trading and non-trading VAR for the Group was Global Markets.

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The histograms below illustrate the frequency of daily revenue arising from Global Markets' trading, balance sheet management and other trading activities.

The average daily revenue earned therefrom in 2007 was US\$18.7 million, compared with US\$21.3 million in 2006. The standard deviation of these daily revenues was US\$25.3 million, compared with US\$11.4 million in 2006. The standard deviation measures the variation of daily revenues about the mean value of those revenues. An analysis of the frequency distribution of daily revenue shows that there were 35 days with negative revenue during 2007, compared with two days in 2006.

### **Daily distribution of Global Markets' trading, balance sheet management and other trading revenues** *(Unaudited)*

*Year ended 31 December 2007*

Number of days

*Year ended 31 December 2006*

Number of days

*The effect of any month-end adjustments, not attributable to a specific daily market move, is spread evenly over the days in the month in question.*

For a description of HSBC's fair value and price verification controls, see Note 33 on the Financial Statements.

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Trading portfolios  
(Audited)

HSBC's control of market risk is based on a policy of restricting individual operations to trading within a list of permissible instruments authorised for each site by Traded Credit and Market Risk, of enforcing rigorous new product approval procedures, and of restricting trading in the more complex derivative products only to offices with appropriate levels of product expertise and robust control systems.

In addition, at both portfolio and position levels, market risk in trading portfolios is monitored and controlled using a complementary set of techniques. These include VAR and, for interest rate risk, present value of a basis point movement in interest rates, together with stress and sensitivity testing and concentration limits. These techniques quantify the impact on capital of defined market movements.

Market making and proprietary position taking is undertaken within Global Markets. The VAR for such trading activity at 31 December 2007 was US\$48.3 million (2006: US\$30.2 million). This is analysed below by risk type:

**VAR by risk type for the trading activities**

(Audited)

	<b>Foreign exchange and Interest commodity</b>	<b>rate</b>	<b>Equity</b>	<b>Total</b>
	US\$m	US\$m	US\$m	US\$m
<b>At 31 December</b>				
<b>2007</b>	<b>11.5</b>	<b>37.5</b>	<b>23.7</b>	<b>48.3</b>
At 31 December				
2006	7.3	27.9	11.8	30.2
Average				
<b>2007</b>	<b>9.9</b>	<b>33.1</b>	<b>15.1</b>	<b>36.7</b>
2006	6.3	31.7	6.5	31.6
Minimum				
<b>2007</b>	<b>4.4</b>	<b>24.2</b>	<b>8.1</b>	<b>26.3</b>
2006	2.6	18.3	2.6	19.9
Maximum				
<b>2007</b>	<b>23.2</b>	<b>47.5</b>	<b>28.1</b>	<b>56.0</b>
2006	12.7	49.6	11.8	48.2

The risk associated with movements in credit spreads is primarily managed through sensitivity limits, stress testing and VAR on those portfolios where VAR is calculated.

The Group is introducing credit spread as a separate risk type within the VAR models and, at 31 December 2007, credit spread VAR was calculated for the London trading and New York credit derivatives portfolios. At that date, the total VAR for the trading activities, including credit spread VAR for the above portfolios, was US\$60.1 million.

The effect of movements in credit spreads on the Group's trading portfolio became more significant in 2007 as volatility in these spreads increased in the latter half of 2007. The sensitivity of trading income to the effect of movements in credit spreads on the total trading activities of the Group was US\$95.4 million at 31 December 2007 (2006: US\$27.3 million). This sensitivity was calculated using simplified assumptions based on one-day



movements in average market credit spreads over a two-year period at a confidence level of 99 per cent.

The increase in the sensitivity at 31 December

2007, compared with 31 December 2006, was due to the effect of higher volatility in credit spreads observed in the latter half of 2007. The credit spread positions within the trading portfolios were at a similar level on 31 December 2007 compared with 31 December 2006.

Credit spread risk also arises on credit derivative transactions entered into by Global Banking. The purpose of these transactions is to manage the risk concentrations within the corporate loan portfolio and so enhance capital efficiency. The mark-to-market of these transactions is taken through the profit and loss account.

At 31 December 2007, the credit spread VAR on the credit derivatives transactions entered into by Global Banking was US\$19.7 million (2006: US\$8.2 million). The VAR shows the effect on trading income from a one-day movement in credit spreads over a two-year period, calculated to a 99 per cent confidence level.

HSBC augments its VAR measures with a series of stress scenarios to determine the potential loss arising from market moves that are outside the 99 per cent confidence level measured by VAR.

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HSBC HOLDINGS PLC

## **Report of the Directors: The Management of Risk** (continued)

### *Market risk > Trading portfolios / Non-trading portfolios*

The stress scenarios cover a range of potential market events, such as the hypothetical breaking of a currency peg or the historical observation of market moves during previous periods of stress which would not be captured within VAR. The scenarios provide senior management with an assessment of the financial impact such events would have on the profit and loss of HSBC. The daily losses experienced during 2007 were within the stress loss scenarios reported to senior management.

Certain transactions are structured such that the risk to HSBC is negligible under a wide range of market conditions or events, but in which there exists a remote probability that a significant gap event could lead to loss. A gap event could be seen as a change in market price from one level to another with no trading opportunity in between, and where the price change breaches the threshold beyond which the risk profile changes from having no open risk to having full exposure to the underlying structure. Such movements may occur, for example, when there are adverse news announcements and the market for a specific investment becomes illiquid, making hedging impossible.

Given the characteristics of these transactions, they will make little or no contribution to VAR or to traditional market risk sensitivity measures. HSBC captures the risks for such transactions within the stress testing scenarios. Gap risk arising is monitored on an ongoing basis, and HSBC incurred no gap losses on such transactions in 2007.

#### Non-trading portfolios (Audited)

The principal objective of market risk management of non-trading portfolios is to optimise net interest income.

Market risk in non-trading portfolios arises principally from mismatches between the future yield on assets and their funding cost, as a result of interest rate changes. Analysis of this risk is complicated by having to make assumptions on embedded optionality within certain product areas such as the incidence of mortgage prepayments, and from behavioural assumptions regarding the economic duration of liabilities which are contractually repayable on demand such as current accounts. The prospective change in future net

interest income from non-trading portfolios will be reflected in the current realisable value of these positions, should they be sold or closed prior to maturity. In order to manage this risk optimally, market risk in non-trading portfolios is transferred to Global Markets or to separate books managed under the supervision of the local ALCO.

The transfer of market risk to books managed by Global Markets or supervised by ALCO is usually achieved by a series of internal deals between the business units and these books. When the behavioural characteristics of a product differ from its contractual characteristics, the behavioural characteristics are assessed to determine the true underlying interest rate risk. Local ALCOs are required to regularly monitor all such behavioural assumptions and interest rate risk positions to ensure they comply with interest rate risk limits established by the Group Management Board.

In certain cases, the non-linear characteristics of products cannot be adequately captured by the risk transfer process. For example, both the flow from customer deposit accounts to alternative investment products and the precise prepayment speeds of mortgages will vary at different interest rate levels, and where expectations about future moves in interest rates change. In such circumstances, simulation modelling is used to identify the impact

of varying scenarios on valuations and net interest income.

Once market risk has been consolidated in Global Markets or ALCO-managed books, the net exposure is typically managed through the use of interest rate swaps within agreed limits. The VAR for these portfolios is included within the Group VAR (see "Value at risk" above).

Fixed-rate securities  
*(Audited)*

Market risk also arises on fixed-rate securities issued by HSBC Holdings. These securities are managed as capital instruments and include non-cumulative preference shares, non-cumulative perpetual preferred securities and fixed-rate subordinated debt. The interest rate VAR for these capital instruments, which is not included within Group VAR, was as follows:

[Back to Contents](#)**Capital instruments VAR***(Audited)*

	<b>VAR US\$m</b>
<b>At 31 December 2007</b>	<b>104.7</b>
At 31 December 2006 <sup>1</sup>	73.7
Average	
<b>2007</b>	<b>75.8</b>
2006 <sup>1</sup>	64.0
Minimum	
<b>2007</b>	<b>61.8</b>
2006 <sup>1</sup>	57.0
Maximum	
<b>2007</b>	<b>105.4</b>
2006 <sup>1</sup>	73.7

1 *Restated to reflect securities issued by HSBC Holdings only. All other issued fixed-rate securities are included within the VAR for the Group.*

At 31 December 2007, the sensitivity of equity to the effect of movements in credit spreads on the Group's available-for-sale debt securities was US\$206.5 million (2006: US\$52.0 million). The sensitivity was calculated on the same basis as applied to the trading portfolio. Including the gross exposure for the SIVs consolidated within HSBC's balance sheet at 31 December 2007, the sensitivity increased to US\$279.8 million. This sensitivity is struck, however, before taking account of any losses which would be absorbed by the income note holders. At 31 December 2007, the income note holders would have absorbed the first US\$1.3 billion of any losses incurred by the SIVs prior to HSBC incurring any equity losses.

The increase in this sensitivity at 31 December 2007, compared with 31 December 2006, was due to the effect of higher volatility in credit spreads observed in the latter half of 2007.

## Equity securities classified as available for sale

*(Audited)*

Market risk arises on equity securities held as available for sale. The fair value of these securities at 31 December 2007 was US\$12.6 billion (2006: US\$8.3 billion) and included private equity holdings of US\$3.2 billion (2006: US\$0.9 billion). Investments in private equity are primarily made through managed funds that are subject to limits on the amount of investment. Potential new commitments are subject to risk appraisal to ensure that industry and geographical concentrations remain within acceptable levels for the portfolio as a whole. Regular reviews are performed to substantiate the valuation of the investments within the portfolio and Group Finance is responsible for reviewing the carrying value of the investments. Funds typically invested for short-term cash management represented US\$3.1 billion (2006: US\$2.6 billion),

Investments held to facilitate ongoing business, such as holdings in government-sponsored enterprises and local stock exchanges, represented US\$1.7 billion (2006: US\$1.3 billion). Other strategic investments represented US\$4.6 billion (2006: US\$3.5 billion). The fair value of the constituents of equity securities classified as available for sale can fluctuate considerably. A 10 per cent reduction in the value of the available-for-sale equities at 31 December 2007 would have reduced equity by US\$1.3 billion (2006: US\$0.8 billion).

## Defined benefit pension scheme

*(Audited)*

Market risk also arises within HSBC's defined benefit pension schemes to the extent that the obligations of the schemes are not fully matched by assets with determinable cash flows. Pension scheme obligations are subject to change due to fluctuations in long-term interest rates as well as factors such as changes in inflation, salary increases and scheme members living longer. The pension scheme assets will include equities and debt securities, the cash flows of which will change as equity prices and interest rates vary. The risks are that market

movements in equity prices and interest rates could result in assets which are insufficient over time to cover the level of projected obligations. In addition, increases in inflation and members living longer could increase the pension scheme obligations. Management, together with the trustees who act on behalf of the pension scheme beneficiaries, assess the level of this risk using reports prepared by independent external actuaries and take action, where appropriate, in terms of setting investment strategy and agreeing contribution levels. For example, in order to mitigate the risk of adverse movements in investments, interest rates and inflation, the Trustee of the HSBC Bank (UK) Pension Scheme has continued to implement a programme of initiatives proposed by HSBC, including reducing the equity content of the investment strategy and increasing the diversification of the investments, and entering into long-term interest rate and inflation swaps.

The present value of HSBC's defined benefit pension plans' liabilities was US\$32.4 billion at 31 December 2007, compared with US\$32.2 billion at 31 December 2006. Assets of the defined benefit schemes at 31 December 2007 comprised equity investments, 26 per cent (2006: 30 per cent); debt securities, 62 per cent (2006: 56 per cent); and other (including property), 12 per cent (2006: 14 per cent) (see Note 8 on the Financial Statements).

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HSBC HOLDINGS PLC

**Report of the Directors: The Management of Risk** (continued)*Market risk > Non-trading portfolios / Sensitivity of NII*

Increased corporate bond yields in the UK over the period have resulted in an increase of 40 basis points in the real discount rate (net of the increase in expected inflation) used to value the net present value of the benefits payable of the HSBC Bank (UK) Pension Scheme, the Group's largest plan. In addition, the plan assets of the scheme have increased due to a special contribution to the scheme of US\$0.6 billion. Primarily as a result of these factors, the deficit on HSBC's defined benefit plans has decreased to US\$2 billion from US\$4.6 billion.

Sensitivity of net interest income  
(Unaudited)

A principal part of HSBC's management of market risk in non-trading portfolios is to monitor the sensitivity of projected net interest income under varying interest rate scenarios (simulation modelling). HSBC aims, through its management of market risk in non-trading portfolios, to mitigate the effect of prospective interest rate movements which could reduce future net interest income, while balancing the cost of such hedging activities on the current net revenue stream.

For simulation modelling, businesses use a

combination of scenarios relevant to local businesses and local markets and standard scenarios which are required throughout HSBC. The standard scenarios are consolidated to illustrate the combined pro forma effect on HSBC's consolidated portfolio valuations and net interest income.

The table below sets out the effect on future net interest income of an incremental 25 basis points parallel fall or rise in all yield curves worldwide at the beginning of each quarter during the 12 months from 1 January 2008. Assuming no management actions, a series of such rises would decrease planned net interest income for 2008 by US\$503 million (2007: US\$578 million), while a series of such falls would increase planned net interest income by US\$525 million (2007: US\$511 million). These figures incorporate the effect of any option features in the underlying exposures.

Instead of assuming that all interest rates move together, HSBC groups its interest rate exposures into currency blocs whose rates are considered likely to move together. The sensitivity of projected net interest income, on this basis, is as follows:

**Sensitivity of projected net interest income**  
(Unaudited)

**Rest of****Rest of**

	US dollar bloc US\$m	Americas bloc US\$m	Hong Kong dollar bloc US\$m	Asia bloc US\$m	Sterling bloc US\$m	Euro bloc US\$m	Total US\$m
<b>Change in 2008 projected net interest income arising from a shift in yield curves of:</b>							
+25 basis points at the beginning of each quarter	(275)	96	9	77	(140)	(270)	(503)
-25 basis points at the beginning of each quarter	272	(95)	11	(65)	142	260	525
Change in 2007 projected net interest income arising from a shift in yield curves of:							
+25 basis points at the beginning of each quarter	(342)	53	(32)	18	(163)	(112)	(578)
-25 basis points at the beginning of each quarter	249	(53)	52	(14)	164	113	511

The interest rate sensitivities set out in the table above are illustrative only and are based on simplified scenarios. The figures represent the effect of the pro-forma movements in net interest income based on the projected yield curve scenarios and the Group's current interest rate risk profile. This effect, however, does not incorporate actions that would be taken by Global Markets or in the business units to mitigate the impact of this interest rate risk. In

reality, Global Markets seeks proactively to change the interest rate risk profile to minimise losses and optimise net revenues. The projections above also assume that interest rates of all maturities move by the same amount and, therefore, do not reflect the potential impact on net interest income of some rates changing while others remain unchanged. The projections take account of the anticipated net interest income impact of rate change differences

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between interbank interest rates and interest rates linked to other bases (such as Central Bank rates or product rates over which the entity has discretion in terms of the timing and extent of rate changes). The projections make other simplifying assumptions too, including that all positions run to maturity.

HSBC's exposure to the effect of movements in interest rates on its net interest income arise in three main areas: core deposit franchises, HSBC Finance and Global Markets.

- Core deposit franchises: these are exposed to changes in the cost of deposits raised and spreads on wholesale funds. In a low interest rate environment, the net interest income benefit of core deposits increases as interest rates rise and decreases as interest rates fall. This risk is asymmetrical in a very low interest rate environment, however, as there is limited room to lower deposit pricing in the event of interest rate reductions.
- HSBC Finance reduces the sensitivity of the core deposit franchises to interest rate reductions. This arises from the fact that HSBC Finance has a substantial fixed rate, real estate secured, lending portfolio which is primarily funded with interest rate sensitive short-term liabilities.
- Residual interest rate risk is managed within Global Markets, under the Group's policy of transferring interest rate risk to Global Markets to be managed within defined limits and with flexibility as to the instruments used. The main drivers of change in the sensitivity of the Group's net interest income to the changes in interest rates tabulated above were:
  - There has been an overall increase in benefit from rising rates and an increase in exposure to falling rates due to general growth in core deposits.
  - The average life of certain US mortgage assets has increased due to a reduction in the predicted rate of refinancing, increasing the benefit from reducing US dollar rates.
  - Global Markets increased euro-denominated net trading asset positions leading to increased sensitivity in this currency to both rising and falling rates. The funding of net trading assets is generally sourced from floating rate retail deposits and recorded in "Net interest income" whereas the income from such assets is recorded in "Net trading income". Additionally, balance sheet management increased its exposure to euro-denominated assets in non-trading portfolios, adding to the increased sensitivity.

It can be seen from the above that projecting the movement in net interest income from prospective changes in interest rates is a complex interaction of structural and managed exposures.

HSBC monitors the sensitivity of reported reserves to interest rate movements on a monthly basis by assessing the expected reduction in valuation of available-for-sale portfolios and cash flow hedges due to parallel movements of plus or minus 100 basis points in all yield curves. The table below describes the sensitivity of HSBC's reported reserves to these movements at the end of 2007 and 2006 and the maximum and minimum month-end figures during these years:

### Sensitivity of reported reserves to interest rate movements

(Unaudited)

	US\$m	Maximum impact US\$m	Minimum impact US\$m
<b>At 31 December 2007</b>			
+ 100 basis point parallel move in all yield curves	<b>(1,737)</b>	<b>(1,738)</b>	<b>(1,519)</b>
As a percentage of total shareholders' equity	<b>(1.4%)</b>	<b>(1.4%)</b>	<b>(1.2%)</b>
- 100 basis point parallel move in all yield curves	<b>1,977</b>	<b>2,048</b>	<b>1,430</b>
As a percentage of total shareholders' equity	<b>1.5%</b>	<b>1.6%</b>	<b>1.1%</b>



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At 31 December 2006

+ 100 basis point parallel move in all yield curves	(1, 558)	(2,015)	(1,358)
As a percentage of total shareholders' equity	(1.4%)	(1.9%)	(1.3%)
- 100 basis point parallel move in all yield curves	1,456	1,944	1,270
As a percentage of total shareholders' equity	1.3%	1.8%	1.2%

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HSBC HOLDINGS PLC

## **Report of the Directors: The Management of Risk** (continued)

*Market risk > Structural foreign exchange exposures / HSBC Holdings / Areas of special interest*

The sensitivities are illustrative only and are based on simplified scenarios. The table shows interest rate risk exposures arising in available-for-sale portfolios and from cash flow hedges which are marked-to-market through reserves. These particular exposures form only a part of the Group's overall interest rate exposures. The accounting treatment under IFRSs of the Group's remaining interest rate exposures, while economically largely offsetting the exposures shown in the above table, does not require revaluation movements to go to reserves.

Structural foreign exchange exposures  
(Unaudited)

Structural foreign exchange exposures represent net investments in subsidiaries, branches or associated undertakings, the functional currencies of which are currencies other than the US dollar.

Exchange differences on structural exposures are recorded in the consolidated statement of recognised income and expense. The main operating (or functional) currencies in which HSBC's business is transacted are the US dollar, the Hong Kong dollar, pound sterling, the euro, the Mexican peso, the Brazilian real and the Chinese renminbi. As the US dollar and currencies linked to it form the dominant currency bloc in which HSBC's operations transact business, HSBC Holdings prepares its consolidated financial statements in US dollars. HSBC's consolidated balance sheet is, therefore, affected by exchange differences between the US dollar and all the non-US dollar functional currencies of underlying subsidiaries.

HSBC hedges structural foreign exchange exposures only in limited circumstances. HSBC's structural foreign exchange exposures are managed with the primary objective of ensuring, where practical, that HSBC's consolidated capital ratios and the capital ratios of individual banking subsidiaries are protected from the effect of changes in exchange rates. This is usually achieved by ensuring that, for each subsidiary bank, the ratio of structural exposures in a given currency to risk-weighted assets denominated in that currency is broadly equal to the capital ratio of the subsidiary in question.

Selective hedges were in place during 2006 and 2007. Hedging is undertaken using forward foreign exchange contracts which are accounted for under IFRSs as hedges of a net investment in a foreign operation, or by financing with borrowings in the same currencies as the functional currencies involved. There was no ineffectiveness arising from these hedges in the year ended 31 December 2007.

There was no material effect from exchange differences on HSBC's capital ratios during the year.

HSBC Holdings  
(Audited)

As a financial services holding company, HSBC Holdings has limited market risk activity. Its activities predominantly involve maintaining sufficient capital resources to support the Group's diverse activities; allocating these capital resources across the Group's businesses; earning dividend and interest income on its investments in the Group's businesses; providing dividend payments to HSBC Holding's equity shareholders and interest payments to providers of debt capital; and maintaining a supply of short-term cash resources. It does not take proprietary trading positions.

The main market risks to which HSBC Holdings is exposed are interest rate risk and foreign currency risk. Exposure to these risks arises from short-term cash balances, funding positions held, loans to subsidiaries, investments in long-term financial assets and financial liabilities including debt capital issued. The objective of HSBC Holding's market risk management strategy is to reduce exposure to these risks and minimise volatility in reported income, cash flows and distributable reserves. Market risk for HSBC Holdings is monitored by its Structural Positions Review Group.

Certain loans to subsidiaries of a capital nature that are not denominated in the functional currency of either the provider or the recipient are accounted for as financial assets. Changes in the carrying amount of these assets due to exchange differences are taken directly to the income statement. These loans, and the associated foreign exchange exposures, are eliminated on a Group consolidated basis.

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Total VAR arising within HSBC Holdings in 2007 and 2006 was as follows:

**Value at risk □ HSBC Holdings***(Audited)*

	<b>Foreign exchange US\$m</b>	<b>Interest rates US\$m</b>	<b>Total US\$m</b>
<b>At 31 December 2007</b>	<b>49.1</b>	<b>97.7</b>	<b>105.0</b>
At 31 December 2006	30.8	61.4	66.4
Average			
<b>2007</b>	<b>33.6</b>	<b>66.0</b>	<b>68.1</b>
2006	27.4	43.6	49.2
Minimum			
<b>2007</b>	<b>29.2</b>	<b>52.7</b>	<b>53.3</b>
2006	23.2	30.7	34.8
Maximum			
<b>2007</b>	<b>49.1</b>	<b>97.7</b>	<b>105.0</b>
2006	32.0	61.4	66.4

The increase in total VAR during 2007 was mainly due to the increase in volatility of interest rates and new debt capital issues made in the year.

*(Unaudited)*

A principal tool in the management of market risk is the projected sensitivity of HSBC Holdings' net interest income to future changes in yield curves.

The table below sets out the effect on HSBC Holdings' future net interest income of an incremental 25 basis point parallel fall or rise in all yield curves worldwide at the beginning of each quarter during the 12 months from 1 January 2008.

Assuming no management action, a series of such rises would decrease HSBC Holdings' planned net interest income for 2008 by US\$23 million (2007: increase of US\$8 million) while a series of such falls would increase planned net interest income by US\$23 million (2007: decrease of US\$8 million). These figures incorporate the impact of any option features in the underlying exposures.

Instead of assuming that all interest rates move together, HSBC groups its interest rate exposures into currency blocs whose interest rates are considered likely to move together. The sensitivity of projected net interest income, on this basis, is described as follows:

**Sensitivity of HSBC Holdings' net interest income to interest rate movements***(Unaudited)*

	<b>US dollar bloc US\$m</b>	<b>Sterling bloc US\$m</b>	<b>Euro bloc US\$m</b>	<b>Total US\$m</b>
<b>Change in 2008 projected net interest income arising from a shift in yield curves of:</b>				
+25 basis points at the beginning of each quarter	<b>(51)</b>	<b>16</b>	<b>12</b>	<b>(23)</b>
□25 basis points at the beginning of each quarter	<b>51</b>	<b>(16)</b>	<b>(12)</b>	<b>23</b>
Change in 2007 projected net interest income arising from a shift in yield curves of:				

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+25 basis points at the beginning of each quarter	(7)	6	9	8
□25 basis points at the beginning of each quarter	7	(6)	(9)	(8)

HSBC Holdings' principal exposure to changes in its net interest income from movements in interest rates arises on short-term cash balances, floating rate loans advanced to subsidiaries and fixed rate debt capital securities in issue which have been swapped to floating rate.

The interest rate sensitivities tabulated above are illustrative only and are based on simplified scenarios. The figures represent the effect of pro forma movements in net interest income based on the projected yield curve scenarios and HSBC Holdings' current interest rate risk profile. They do not take into account the effect of actions that could be taken to mitigate this interest rate risk, however.

The projected increase in HSBC Holdings' sensitivity to moves in interest rates is mainly due to new interest-bearing capital issues, the funds from which have been largely invested in non-interest bearing equity investments in subsidiaries.

Areas of special interest □ market risk

*(Audited)*

In the second half of 2007, credit risk concerns emanating from the US sub-prime mortgage market led to a deterioration in the fair value of assets supported by sub-prime mortgages. However, there was a consequential impact beyond sub-prime related assets and, to a lesser degree, fair value

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HSBC HOLDINGS PLC

**Report of the Directors: The Management of Risk** (continued)*Market risk > Areas of special interest / Monoline insurers*

deterioration occurred in US mortgage-related financial instruments generally, with financial instruments issued by non-US government sponsored entities more significantly affected than sponsored financial instruments.

The following table shows the net market risk arising from HSBC's exposure to US mortgage loans held at fair value through profit or loss, and US mortgage-backed securities (MBSs) including those represented by collateralised debt obligations (CDOs). HSBC's exposures arise from the following activities:

- purchase of sub-prime whole loans with the intention of structuring and placing securitisations into the market;
- secondary market trading activities; and
- holding of MBSs as part of investment portfolios including the HSBC consolidated SIVs and conduits.

Unrealised and realised gains and losses arising from securitisation and secondary market trading activity are recognised in the income statement, while changes in fair value of the investment portfolio and the SIV and conduit portfolios are recognised in equity. US MBSs are primarily measured at fair value; a small proportion of high grade securities are classified as held-to-maturity and measured at amortised cost. There are no significant differences between fair value and carrying amount for these US MBSs measured at amortised cost.

HSBC's principal exposure to the US mortgage market is via credit risk from loans and advances to customers, details of which are set out from page 216.

*(Audited)*

	Principal <sup>1</sup> US\$m	Carrying amount US\$m	Unrealised gains and losses <sup>2</sup> US\$m	Realised gains and losses <sup>2</sup> US\$m	Fair value movements recognised <sup>3</sup> US\$m
<b>Year ended 31 December 2007</b>					
<b>US sub-prime mortgage-related assets<sup>4</sup></b>					
Direct lending	2,692	2,231	(383)	(221)	□
MBSs <sup>5</sup>	5,733	5,146	(557)	(69)	(187)
□ high grade (AA or AAA rated)	5,233	4,909	(114)		(187)
□ rated C to A	443	186	(275)		□
□ not publicly rated	57	51	(168)		□
MBS CDOs <sup>5</sup>	701	560	(97)	12	(43)
□ high grade (AA or AAA rated)	665	531	(95)		(38)
□ rated C to A	36	29	(2)		(5)
□ not publicly rated	□	□	□		□

	<b>9,126</b>	<b>7,937</b>	<b>(1,037)</b>	<b>(278)</b>	<b>(230)</b>
<b>Other US mortgage-related assets</b>					
Direct lending	<b>762</b>	<b>756</b>	<b>(4)</b>	<b>41</b>	□
MBSs <sup>5</sup>	<b>47,958</b>	<b>46,320</b>	<b>(181)</b>	<b>(38)</b>	<b>(1,051)</b>
□ high grade (AA or AAA rated)	<b>47,859</b>	<b>46,254</b>	<b>(147)</b>		<b>(1,051)</b>
□ rated C to A	<b>87</b>	<b>54</b>	<b>(34)</b>		□
□ not publicly rated	<b>12</b>	<b>12</b>	□		□
	<b>48,720</b>	<b>47,076</b>	<b>(185)</b>	<b>3</b>	<b>(1,051)</b>

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	Principal <sup>1</sup> US\$m	Carrying amount US\$m	Unrealised gains and losses <sup>2</sup> US\$m	Realised gains and losses <sup>2</sup> US\$m	Fair value movements recognised <sup>3</sup> US\$m
Year ended 31 December 2006					
US sub-prime mortgage-related assets					
Direct lending	4,947	4,997	(11)	227	□
MBSs <sup>5</sup>	2,986	2,944	(41)	5	2
□ high grade (AA or AAA rated)	2,640	2,641	1		2
□ rated C to A	155	146	(1)		□
□ not publicly rated	191	157	(41)		□
MBS CDOs <sup>5</sup>	326	325	□	□	□
□ high grade (AA or AAA rated)	326	325	□		□
□ rated C to A	□	□	□		□
□ not publicly rated	□	□	□		□
	<u>8,259</u>	<u>8,266</u>	<u>(52)</u>	<u>232</u>	<u>2</u>
Other US mortgage-related assets					
Direct lending	1,317	1,322	2	45	□
MBSs <sup>5</sup>	40,001	38,691	(72)	70	(42)
□ high grade (AA or AAA rated)	39,825	38,531	(59)		(42)
□ rated C to A	136	132	□		□
□ not publicly rated	40	28	(13)		□
	<u>41,318</u>	<u>40,013</u>	<u>(70)</u>	<u>115</u>	<u>(42)</u>

- 1 The principal is the redemption amount on maturity or, in the case of an amortising instrument, the sum of the future redempti on amounts through the residual life of the security.
- 2 Recognised during the year in the income statement.
- 3 Fair value gains and losses recognised during the year in equity.
- 4 HSBC has primarily utilised loan counterparty credit scores as the basis for determining whether an asset is classified as sub- prime.
- 5 Mortgage-backed securities (□MBSs□) and collateralised debt obligations (□CDOs□).

In addition to the exposure detailed above, HSBC also holds long positions in MBSs with a carrying value of US\$1,633 million (2006: US\$963 million) and MBS CDOs with a carrying value of US\$349 million (2006: US\$608 million) where the exposure has been matched by specific credit derivatives with monolines and other financial institutions. The counterparty credit risk arising from the derivative transactions undertaken with monolines is included in the monoline exposure analysis detailed on page 260.

### HSBC's exposure to derivative transactions entered into directly with monoline insurers

(Audited)

HSBC's principal exposure to monoline insurers is through a number of OTC derivative transactions, primarily credit default swaps (□CDSs□). HSBC has entered into CDSs to purchase credit protection against securities held within the trading portfolio.

During the second half of 2007, the market value of the securities declined, with offsetting increases in the mark-to-market value of the CDS transactions, thereby increasing OTC counterparty credit risk to the monoline insurers. The table below sets out the mark-to-market value of the derivative contracts at 31 December 2007, and hence the amount at risk, based on 31 December 2007 security prices, if the CDS protection purchased were to be wholly ineffective because, for example, the monoline insurer was unable to meet its obligations. In order to



assess that risk, protection purchased is sub-divided between those monoline insurers that had external investment grade ratings at 25 February 2008, and those that did not. The "Credit Risk Adjustment" column indicates the valuation adjustment taken against the mark-to-market exposures, and reflects the deterioration in creditworthiness of the monoline insurers during 2007. These adjustments have been charged to the income statement.

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HSBC HOLDINGS PLC

**Report of the Directors: The Management of Risk** (continued)

Residual value risk management / Operational risk management  
> Legal risk

HSBC's exposure to derivative transactions entered into directly with monoline insurers  
(Audited)

	Net exposure before credit risk adjustment <sup>1</sup> US\$m	Credit risk adjustment <sup>2</sup> US\$m	Net exposure after credit risk adjustment US\$m
<b>At 31 December 2007</b>			
Derivative transactions with monoline counterparties:			
□ Monoline □ investment grade	1,342	(133)	1,209
□ Monoline □ below investment grade	214	(214)	□
	<u>1,556</u>	<u>(347)</u>	<u>1,209</u>
<b>At 31 December 2006</b>			
Derivative transactions with monoline counterparties:			
□ Monoline □ investment grade	9	□	9
	<u>9</u>	<u>□</u>	<u>9</u>

- 1 Net exposure after legal netting and any other relevant credit mitigation prior to deduction of credit risk adjustment.
- 2 Fair value adjustment recorded against over-the-counter derivative counterparty exposures to reflect the credit worthiness of the counterparty.

**HSBC's exposure to debt securities which benefit from guarantees provided by monoline insurers**  
(Audited)

Within both the trading and available-for-sale portfolios, HSBC holds bonds that are □wrapped□ with a credit enhancement from a monoline insurer. Any deterioration in the credit profile of the monoline insurer is reflected in market prices and therefore in the carrying value of these securities in HSBC's balance sheet at 31 December 2007. For wrapped bonds held in the trading portfolio, the mark-to-market loss has been reflected through the income statement. For wrapped bonds held in the available-for-sale portfolio, the mark-to-market deterioration is reflected in equity unless the impairment is regarded as permanent, in which case it is reflected in the income statement. There was no permanent impairment recognised in respect of these assets at 31 December 2007.

**HSBC's exposure to direct lending and irrevocable commitments to lend to monoline insurers**  
(Audited)

HSBC has extended liquidity facilities totalling US\$158 million to monoline insurers, none of which was drawn at 31 December 2007 (31 December 2006: US\$145 million, none of which was drawn).

**Residual value risk management**

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*(Unaudited)*

A significant part of a lessor's return from operating leases is dependent upon its management of residual value risk. This arises from operating lease transactions to the extent that the values recovered from disposing of leased assets or re-letting them at the end of the lease terms (the "residual values") differ from those projected at the inception of the

leases. The business regularly monitors residual value exposure by reviewing the recoverability of the residual value projected at lease inception. This entails considering the potential of re-letting of operating lease assets and their projected disposal proceeds at the end of their lease terms. Provision is made to the extent that the carrying values of leased assets are impaired through residual values not being fully recoverable.

The net book value of equipment leased to customers on operating leases by the Group includes projected residual values at the end of current lease terms, to be recovered through re-letting or disposal in the following periods:

### **Residual values**

*(Unaudited)*

	<b>2007</b>	2006
	<b>US\$m</b>	US\$m
Within 1 year	<b>155</b>	200
Between 1-2 years	<b>243</b>	414
Between 2-5 years	<b>713</b>	379
More than 5 years	<b>1,892</b>	1,996
	<hr/>	<hr/>
Total exposure	<b>3,003</b>	2,989
	<hr/>	<hr/>

### **Operational risk management**

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*(Unaudited)*

Operational risk is the risk of loss arising from fraud, unauthorised activities, error, omission, inefficiency, systems failure or external events. It is inherent in every business organisation and covers a wide spectrum of issues.

HSBC manages this risk through a controls-based environment in which processes are documented, authorisation is independent and transactions are reconciled and monitored. In each of HSBC's subsidiaries, local management is responsible for the review and supervision of the operation of these controls. The control environment

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in each subsidiary is subject to an independent programme of periodic reviews undertaken by Internal Audit. This is supported by the monitoring of external operational risk events, which ensures that HSBC stays in line with industry best practice and takes account of lessons learned from publicised operational failures within the financial services industry.

HSBC has codified its operational risk management framework by issuing a high level standard, supplemented by more detailed formal policies. The detailed policies explain HSBC's approach to identifying, assessing, monitoring and controlling operational risk, give guidance on remedial action to be taken when rectifying operational risk events and set out responsibilities for meeting local regulatory requirements. Processes undertaken to manage operational risk are determined by reference to the scale and nature of each HSBC operation. The HSBC standard covers the following:

- operational risk management responsibility is assigned to senior management within each business operation;
- information systems are used to record the identification and assessment of operational risks and to generate appropriate, regular operational risk reporting;
- assessments are undertaken of the operational risks facing each business and the risks inherent in its processes, activities and products. Risk assessments incorporate an evaluation of the effectiveness of controls and are regularly reviewed to identify significant changes;
- operational risk loss data is collected and reported to senior management at the business unit level. Aggregate operational risk losses are recorded and details of incidents above a materiality threshold are reported to Group Head Office. A regular report on operational losses is made to Group Audit Committee and the Risk Management Meeting; and
- risk mitigation, including insurance, is considered where this is cost-effective.

In each of HSBC's subsidiaries, local management is responsible for implementing HSBC standards on operational risk throughout their operations and, where deficiencies are evident, rectifying them within a reasonable timeframe. Subsidiaries acquired by HSBC are required to assess, plan and implement the standard's requirements within an agreed timescale.

HSBC maintains and tests contingency facilities to support operations in the event of disasters. Additional reviews and tests are conducted in the event that any HSBC office is affected by a business disruption event to incorporate lessons learned in the operational recovery from those circumstances. As part of HSBC's contingency planning, all country managers have prepared plans for the operation of their businesses with reduced staffing levels, should a flu pandemic occur. Country managers are required to update these plans as circumstances change.

Legal risk  
(Unaudited)

Each operating company is required to implement policies, procedures and guidelines in respect of the management and control of legal risk which conform to HSBC standards. Legal risk falls within the definition of operational risk and includes contractual risk, legislative risk, intellectual property risk and litigation risk. Legal risk is the risk of:

- failing to act appropriately or diligently in response to a claim made against any HSBC company;
- failing to take the proper action to preserve recourse to insurers in respect of any claim against an HSBC company;
- being unable to successfully defend a claim brought against any HSBC company;
- HSBC being unable to take action to enforce its rights through the courts; or
- failing to take steps to mitigate the likelihood that a claim will be made against an HSBC company.

HSBC has a dedicated global legal function which is responsible for managing legal risk. This comprises the provision of legal advice and support in resisting claims and legal proceedings against HSBC companies, including analysis of legal issues and the management of any litigation, as well as in respect of non-routine debt recoveries or other litigation against third parties.

The Head Office legal department oversees the global legal function and is headed by a Group General Manager who reports to the Group Chairman. There are legal departments in 56 of the countries in which HSBC operates which have primary responsibility for identifying and assessing legal risk and advising local management in their respective jurisdictions on these matters. There is also a regional-level legal function in each of Europe, North America, Latin America, the Middle East, and Asia-Pacific.

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HSBC HOLDINGS PLC

## **Report of the Directors: The Management of Risk** (continued)

*Pension risk / Reputational risk management / Sustainability risk management*

HSBC policy requires operating companies to notify the appropriate in-house legal department immediately any litigation is either threatened or commenced against the Group or an employee. Claims which exceed US\$1.5 million must be advised immediately to the appropriate regional legal department. Claims where the amount exceeds US\$5 million, where the action is by a regulatory authority, where the proceedings are criminal, or where the claim might materially affect the Group's reputation must immediately be advised to the Head Office legal department. Such matters are then advised to the Risk Management Meeting of the Group Management Board in a monthly paper.

HSBC policy also requires that an exception report must be made to the local compliance function and escalated to the Head of Group Compliance in respect of any breach which has given rise to a fine and/or costs levied by a court of law or regulatory body where the amount is US\$1,500 or more, and material or significant issues are reported to the Risk Management Meeting of the Group Management Board and/or the Group Audit Committee.

In addition, operating companies are required to submit quarterly returns detailing outstanding claims where the claim (or group of similar claims) exceeds US\$10 million, where the action is by a regulatory authority, where the proceedings are criminal, where the claim might materially affect the Group's reputation, or, where the Head Office legal department has requested returns be completed for a particular claim. These returns are used for reporting to the Group Audit Committee and the Board of HSBC Holdings, and disclosure in the *Interim Report* and *Annual Report and Accounts* if appropriate.

Global security and fraud risk  
(Unaudited)

Security and fraud risk issues are managed at Group level by Global Security and Fraud Risk. This unit, which has responsibility for physical, fraud, information and contingency risk, and security and business intelligence, is now fully integrated within the central Group Risk function. This will facilitate synergies between it and other risk functions, such as with Global Retail Risk Management in the selection, design and implementation of systems and processes to protect the Group against fraud by deterring fraudulent activity, detecting it where it does occur and mitigating its effects.

### **Pension risk**

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(Unaudited)

HSBC operates a number of pension plans throughout the world, as described in Note 8 on the Financial Statements. Some of these pension plans are defined benefit plans, of which the largest is the HSBC Bank (UK) Pension Scheme.

In order to fund these benefits, sponsoring group companies (and in some instances, employees) make regular contributions in accordance with advice from actuaries and in consultation with the scheme's Trustees (where relevant). The defined benefit plans invest these contributions in a range of investments designed to meet their long-term liabilities.

The level of these contributions has a direct impact on the cash flow of the Group and would normally be set to ensure that there are sufficient funds to meet the cost of the accruing benefits for the future service of active members. However, higher contributions will be required when plan assets are considered insufficient to cover the existing pension liabilities as a deficit exists. Contribution rates are typically revised annually or triennially, depending on the plan. The agreed contributions to the HSBC Bank (UK) Pension Scheme are revised triennially.

A deficit in a defined benefit plan may arise from a number of factors, including:

- investments delivering a return below that required to provide the projected plan benefits. This could arise, for example, when there is a fall in the market value of equities, or when increases in long-term interest rates cause a fall in the value of fixed income securities held;
- a change in either interest rates or inflation which causes an increase in the value of the scheme liabilities; and
- scheme members living longer than expected (known as longevity risk).

The plan's investment strategy is determined in the light of the market risk inherent in the investments and the consequential impact on potential future contributions.

Ultimate responsibility for investment strategy rests with either the Trustees or, in certain circumstances, a Management Committee. The degree of independence of the Trustees from HSBC differs in different jurisdictions. For example, the HSBC Bank (UK) Pension Scheme, which accounts for over 40 per cent of the net liability of the Group's pension plans, is overseen by a corporate Trustee. This scheme's Trustee regularly monitors the market risks inherent in the scheme.

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## Reputational risk management

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*(Unaudited)*

The safeguarding of HSBC's reputation is of paramount importance to its continued prosperity and is the responsibility of every member of staff, and HSBC regularly reviews its policies and procedures for safeguarding against reputational and operational risks. This is an evolutionary process which takes account of relevant developments and industry guidance such as The Association of British Insurers' guidance on best practice when responding to environmental, social and governance (ESG) risks.

HSBC has always aspired to the highest standards of conduct and, as a matter of routine, takes account of reputational risks to its business. Reputational risks can arise from a wide variety of causes, including ESG issues and operational risk events. As a banking group, HSBC's good reputation depends upon the way in which it conducts its business, but it can also be affected by the way in which clients, to whom it provides financial services, conduct themselves. The training of Directors on appointment includes reputational matters.

A Reputational Risk Committee (RRC) has been established at which relevant Group functions with responsibility for activities and functions which attract reputational risk are represented. The primary role of the RRC is to consider areas and activities presenting significant reputational risk and, where appropriate, to make recommendations to the Risk Management Meeting and the Group Management Board for policy or procedural changes to mitigate such risk.

Standards on all major aspects of business are set for HSBC and for individual subsidiaries, businesses and functions. Reputational risks, including ESG matters, are considered and assessed by the Board, the Group Management Board, the Risk Management Meeting, subsidiary company boards, board committees and senior management during the formulation of policy and the establishment of HSBC standards. These policies, which form an integral part of the internal control system (see page 304), are communicated through manuals and statements of policy and are promulgated through internal communications and training. The policies cover ESG issues and set out operational procedures in all areas of reputational risk, including money laundering deterrence, environmental impact, anti-corruption measures and employee relations. The policy manuals address risk issues in detail and co-operation between Head Office departments and businesses is required to

ensure a strong adherence to HSBC's risk management system and its corporate responsibility practices.

## Sustainability risk management

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*(Unaudited)*

Sustainability risks arise from the provision of financial services to companies or projects which run counter to the needs of sustainable development; in effect this risk arises when the environmental and social effects outweigh economic benefits. Within Group Head Office, a separate function, Group Corporate Sustainability, is mandated to manage these risks globally. Its risk management responsibilities include:

- formulating sustainability risk policies. This includes oversight of HSBC's sustainability risk standards, management of the Equator Principles for project finance lending, and sector-based sustainability policies covering those sectors with high environmental or social impacts (forestry, freshwater infrastructure, chemicals, energy, mining and metals, and defence-related lending); undertaking an independent review of transactions where sustainability risks are assessed to be high, and supporting HSBC's operating companies to assess similar risks of a lower magnitude;
- building and implementing systems-based processes to ensure consistent application of policies, reduce the costs of sustainability risk reviews and capture management information to measure and report on the effect of HSBC's lending and investment activities on sustainable development; and
- providing training and capacity building within HSBC's operating companies to ensure sustainability risks are identified and mitigated on a consistent basis and to either HSBC's own standards, or international standards or local regulations, whichever is the higher.





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HSBC HOLDINGS PLC

**Report of the Directors: The Management of Risk** (continued)*Insurance operations > Life / Non-life / Insurance risk***Risk management of insurance operations***(Audited)*

HSBC operates a bancassurance model which provides insurance products for customers with whom the Group has a banking relationship. Many of these products are manufactured by HSBC subsidiaries, but where the Group considers it operationally more effective, third parties are engaged to manufacture and provide insurance products which HSBC sells through its banking network. The Group works with a limited number of market-leading partners to provide these products. When manufacturing products, the Group underwrites the insurance risk and retains the risks and rewards associated with writing insurance contracts. HSBC's exposure to risks associated with manufacturing insurance contracts in its subsidiaries and its management of these risks are discussed below.

One advantage of the bancassurance model to HSBC is that, where the Group manufactures products to sell to customers, the underwriting profit is retained within the Group as is the commission paid by the manufacturer to the bank distribution channel. When HSBC sells products provided by third parties, it earns a commission. HSBC sells insurance products across all its customer groups, mainly utilising its retail branches, the internet and phone centres. Personal Financial Services customers attract the majority of sales and comprise the majority of policyholders. HSBC offers its customers a wide range of insurance and investment products, many of which complement other bank and consumer finance products.

HSBC's bancassurance business operates in all five of the Group's geographical regions with over 35 legal entities manufacturing insurance products. The majority of these insurance operations are subsidiaries of banking legal entities and comply with their management control procedures. In addition to local management requirements, the insurance operations follow guidelines issued by the Group Insurance Head Office. The Group Insurance Head Office is headed by the Group's Managing Director of Insurance, supported by a Chief Operating Officer and Chief Finance Officer. The role of Group Insurance Head Office includes setting the control framework for monitoring and measuring insurance risk in line with existing Group practices, and defining insurance-specific policies and guidelines for inclusion in the Group Instruction Manuals. The control framework for monitoring risk includes the Group Insurance Risk Committee, to which four Group Insurance sub-committees report,

focusing on operational risk, insurance risk, market and liquidity risk, and credit risk. The sub-committees of the Group Insurance Risk Committee were introduced during 2007. The processes and controls employed to monitor individual risks are described under their respective headings below. The main contracts manufactured by HSBC are described below.

Life insurance business

*(Audited)*

**Life insurance contracts with discretionary participation features (DPF)** allow policyholders to participate in the profits generated from such business, which may take the form of annual bonuses and a final bonus, in addition to providing cover on death. The largest portfolio, which is in Hong Kong, is a book of endowment and whole-life policies, with annual bonuses awarded to policyholders. In addition, certain minimum return levels are guaranteed.

**Credit life insurance** business is written to underpin banking and finance products. The policy pays a claim if the holder of the loan is unable to make repayments due to early death or unemployment.

**Annuities** are contracts providing regular payments of income from capital investment for either a fixed period or during the annuitant's lifetime. Payments to the annuitant either begin on inception of the policy (immediate annuities) or at a designated future date (deferred annuities).

**Term assurance and critical illness** policies provide cover in the event of death (term assurance) and serious illness.

**Linked life insurance contracts** pay benefits to policyholders which are typically determined by reference to the value of the investments supporting the policies.

**Investment contracts with DPF** allow policyholders to participate in the profits generated by such business. The largest portfolio is written in France. Policyholders are guaranteed to receive a return on their investment plus any discretionary bonuses. In addition, certain minimum return levels are guaranteed.

**Unit-linked investment contracts** are those where the principal benefit payable is the value of assigned assets.

**Other investment contracts** include pension contracts written in Hong Kong.

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Non-life insurance business  
(Audited)

Non-life insurance contracts include motor, fire and other damage to property, accident and health, repayment protection and commercial insurances.

Motor insurance business covers vehicle damage and liability for personal injury. For fire and other damage to property, the predominant focus in most markets is insurance for home and contents for individuals, with cover for selected commercial customers largely written in Asia and Latin America.

A very limited portfolio of liability business is written (other than that which is included in the motor book).

Credit non-life insurance is concentrated in North America and Europe. This business is originated in conjunction with the provision of loans.

Given the nature of the contracts written by the Group, the risk to which the Group insurance operations are exposed falls into two principal categories: insurance risk and financial risk.

The following section describes the nature and extent of the risks that arise in the Group's insurance subsidiaries and the principal approach that HSBC adopts to managing them. The majority of the risk in the insurance business resides in the manufacturing activities.

Insurance risk  
(Audited)

Insurance risk is a risk, other than financial risk, transferred from the holder of a contract to the issuer, in this case HSBC. The principal insurance risk faced by HSBC is that the combined cost of claims, administration and acquisition of the contract may exceed the aggregate amount of premiums received and investment income. The cost of a claim can be influenced by many factors, including mortality and morbidity experience, lapse and surrender rates and, where the policy has a savings element, the performance of the assets held to support the liabilities.

HSBC manages its exposure to insurance risk by applying formal underwriting, reinsurance and claims-handling procedures designed to ensure compliance with regulations and insurance risk appetite, the latter proposed by local businesses and authorised centrally. This is supplemented by undertaking stress testing.

The insurance contracts sold by the Group relate, in the main, to core underlying banking activities such as savings or investment products and

credit life products. The Group's manufacturing focuses on personal lines, i.e. contracts written for individuals. Personal lines tend to be of higher volume and lower individual value than commercial lines, and this diversifies the insurance risk.

Life and non-life business insurance risks are controlled by high level procedures set centrally, supplemented as appropriate with locally-imposed measures which take account of specific local market conditions and regulatory requirements. For example, manufacturing entities are required to obtain authorisation from Group Insurance Head Office to write certain classes of business, with restrictions applying particularly to commercial and liability non-life insurance. Local ALCOs are required to monitor certain risk exposures, in particular for life business.

Reinsurance is also used as a means of mitigating exposure, in particular to aggregations of catastrophe risk. Specific examples are as follows:

- Accident and health insurance. Potential exposure to concentrations of claims arising from particular events, such as earthquakes or a pandemic, are mitigated by the purchase of catastrophe reinsurance.

- Motor insurance. Reinsurance protection is arranged to avoid excessive exposure to larger losses, particularly from personal injury claims.
- Fire and other damage to property. Portfolios at risk from catastrophic losses are protected by reinsurance in accordance with information obtained from professional risk-modelling organisations.

The following tables provide an analysis of the insurance risk exposures by geography and by type of business. By definition, HSBC is not exposed to insurance risk on investment contracts, so they have not been included in the insurance risk management analysis.

Life business tends to be longer-term in nature than non-life business and frequently involves an element of savings and investment in the contract. Separate tables are therefore provided for life and non-life businesses, reflecting their distinctive risk characteristics. The life insurance risk table provides an analysis of insurance liabilities as the best available overall measure of insurance exposure, because provisions for life contracts are typically set by reference to expected future cash outflows relating to the underlying policies. The table for non-life business uses written premiums as the best available measure of risk exposure.

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HSBC HOLDINGS PLC

**Report of the Directors: The Management of Risk** (continued)*Insurance operations > Insurance risk***Analysis of life insurance risk  $\square$  liabilities to policyholders***(Audited)*

	Europe US\$m	Hong Kong US\$m	Rest of Asia- Pacific US\$m	North America US\$m	Latin America US\$m	Total US\$m
<b>At 31 December 2007</b>						
Life (non-linked)						
Insurance contracts with DPF <sup>1</sup>	940	8,489	231	$\square$	$\square$	9,660
Credit life	235	$\square$	$\square$	82	$\square$	317
Annuities	413	$\square$	28	1,154	1,532	3,127
Term assurance and other long-term contracts	675	74	85	125	307	1,266
<b>Total life (non-linked)</b>	<b>2,263</b>	<b>8,563</b>	<b>344</b>	<b>1,361</b>	<b>1,839</b>	<b>14,370</b>
Life (linked)	1,720	2,019	467	$\square$	2,193	6,399
Investment contracts with DPF <sup>1,2</sup>	18,954	$\square$	29	$\square$	$\square$	18,983
<b>Insurance liabilities to policyholders</b>	<b>22,937</b>	<b>10,582</b>	<b>840</b>	<b>1,361</b>	<b>4,032</b>	<b>39,752</b>
<b>At 31 December 2006</b>						
Life (non-linked)						
Insurance contracts with DPF <sup>1</sup>	195	6,001	193	$\square$	$\square$	6,389
Credit life	130	$\square$	$\square$	200	$\square$	330
Annuities	271	$\square$	26	1,106	1,370	2,773
Term assurance and other long-term contracts	1,134	75	89	$\square$	236	1,534
<b>Total life (non-linked)</b>	<b>1,730</b>	<b>6,076</b>	<b>308</b>	<b>1,306</b>	<b>1,606</b>	<b>11,026</b>
Life (linked)	1,270	765	402	$\square$	1,248	3,685
Investment contracts with DPF <sup>1,2</sup>	$\square$	$\square$	20	$\square$	$\square$	20
<b>Insurance liabilities to policyholders</b>	<b>3,000</b>	<b>6,841</b>	<b>730</b>	<b>1,306</b>	<b>2,854</b>	<b>14,731</b>

1 *Insurance contracts and investment contracts with discretionary participation features ( $\square$ DPF $\square$ ) can give policyholders the contractual right to receive, as a supplement to their guaranteed benefits, additional benefits that may be a significant portion of the total contractual benefits, but whose amount and timing is determined by HSBC. These additional benefits are contractually based on the performance of a specified pool of contracts or assets, or the profit of the company issuing the contracts. The increase in investment contracts with DPF resulted from the acquisition in March 2007 of the remaining 50.01 per cent share in HSBC Assurances, the French insurance business, that the Group did not already own, resulting in the consolidation of the assets and liabilities of HSBC Assurances.*

2 *Although investment contracts with DPF are financial investments, HSBC continues to account for them as insurance contracts as permitted by IFRS 4.*

*(Audited)*

The liabilities for long-term contracts are set by reference to a range of assumptions which include lapse and surrender rates, mortality and expense levels. These assumptions are typically set by reference to the entity's own experience. Economic assumptions, such as investment returns and interest rates, are typically set by reference to market observable data.

The above table of liabilities to life insurance policyholders provides an overall summary of HSBC's life insurance activity. In particular, the table highlights that the most significant products are investment contracts with DPF issued in France, insurance contracts with DPF issued in Hong Kong, annuities issued in North America and Latin America and unit-linked contracts issued in Europe, Hong Kong and Latin America.

Insurance risk arising from life insurance depends on the type of business, and varies considerably. The principal risks are mortality, morbidity, lapse, surrender and expense levels.

The main contracts which generate exposure to mortality and morbidity risks are term assurance contracts and annuities. These risks are monitored on a regular basis, and are primarily mitigated by medical underwriting and by retaining the ability in certain cases to amend premiums in the light of experience. The risk associated with lapses and surrenders is generally mitigated by the application of surrender charges. Expense risk can generally be managed through pricing. The level of expenses in the contract will be one of the items considered when setting premiums rates.

[Back to Contents](#)**Analysis of non-life insurance risk □ net written insurance premiums<sup>1</sup>***(Audited)*

	<b>Europe US\$m</b>	<b>Hong Kong US\$m</b>	<b>Rest of Asia- Pacific US\$m</b>	<b>North America US\$m</b>	<b>Latin America US\$m</b>	<b>Total US\$m</b>
<b>2007</b>						
Accident and health	27	132	5	□	25	189
Motor	369	15	10	□	224	618
Fire and other damage	178	23	7	2	19	229
Liability	□	12	3	8	34	57
Credit (non-life)	76	□	□	157	□	233
Marine, aviation and transport	□	12	4	□	18	34
Other non-life insurance contracts	30	24	□	30	24	108
	<u>680</u>	<u>218</u>	<u>29</u>	<u>197</u>	<u>344</u>	<u>1,468</u>
Net insurance claims incurred and movement in liabilities to policyholders	<u>(598)</u>	<u>(90)</u>	<u>(10)</u>	<u>(79)</u>	<u>(151)</u>	<u>(928)</u>
<b>2006</b>						
Accident and health	26	97	5	□	10	138
Motor	185	15	13	□	157	370
Fire and other damage	221	22	5	2	9	259
Liability	1	13	2	8	24	48
Credit (non-life)	264	□	□	173	□	437
Marine, aviation and transport	1	11	3	□	12	27
Other non-life insurance contracts	13	24	□	37	20	94
	<u>711</u>	<u>182</u>	<u>28</u>	<u>220</u>	<u>232</u>	<u>1,373</u>
Net insurance claims incurred and movement in liabilities to policyholders	<u>(451)</u>	<u>(76)</u>	<u>(11)</u>	<u>(79)</u>	<u>(111)</u>	<u>(728)</u>
<b>2005</b>						
Accident and health	33	67	3	3	6	112
Motor	192	20	11	4	302	529
Fire and other damage	251	34	3	5	61	354
Liability	229	17	2	91	14	353
Credit (non-life)	225	□	□	202	□	427
Marine, aviation and transport	□	16	4	□	22	42
Other non-life insurance contracts	10	29	□	17	12	68
	<u>940</u>	<u>183</u>	<u>23</u>	<u>322</u>	<u>417</u>	<u>1,885</u>
Net insurance claims incurred and movement in liabilities to policyholders	<u>(485)</u>	<u>(66)</u>	<u>(9)</u>	<u>(138)</u>	<u>(196)</u>	<u>(894)</u>

1 Net written insurance premiums represent gross written premiums less gross written premiums ceded to reinsurers.



*(Audited)*

The above table of non-life net written insurance premiums provides an overall summary of the non-life insurance activity of the Group. Motor business is written predominantly in Europe and Latin America and represents the largest class of non-life business in 2007. Fire and other damage to property business is written in all major markets, most significantly in Europe. Credit non-life insurance, which is originated in conjunction with the provision of loans, is concentrated in the US and Europe.

The main risks associated with non-life business are underwriting risk and claims experience risk. Underwriting risk is the risk that HSBC does not charge premiums appropriate to the cover provided and claims experience risk is the risk that portfolio experience is worse than expected. HSBC manages these risks through pricing (for example, imposing restrictions and deductibles in the policy terms and conditions), product design, risk selection, claims handling, investment strategy and reinsurance policy. The majority of non-life insurance contracts are renewable annually and the underwriters have the right to refuse renewal or to change the terms and conditions of the contract at the time.

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HSBC HOLDINGS PLC

**Report of the Directors: The Management of Risk** (continued)*Insurance operations > Insurance risk*

Balance sheet of insurance manufacturing subsidiaries by type of contract

(Audited)

	Insurance contracts					Investment contracts					US\$m
	Contracts with DPF <sup>1</sup> US\$m	Unit-linked US\$m	Annuities US\$m	Term assurance <sup>2</sup> US\$m	Non-life US\$m	Contracts with DPF <sup>3</sup> US\$m	Unit-linked US\$m	Other US\$m	Other assets <sup>4</sup> US\$m		
<b>At 31 December 2007</b>											
Financial assets:											
trading assets			37		22				35		94
designated at fair value	3,424	5,799	610	559	130	6,210	12,379	1,610	2,992		33,713
derivatives	2	52			1	78	250	3	30		416
investments	4,518		1,265	328	1,071	12,305		1,526	2,939		23,952
other financial assets	1,896	520	1,047	716	1,175	3	762	714	1,483		8,316
<b>Total financial assets</b>	<b>9,840</b>	<b>6,371</b>	<b>2,959</b>	<b>1,603</b>	<b>2,399</b>	<b>18,596</b>	<b>13,391</b>	<b>3,853</b>	<b>7,479</b>		<b>66,491</b>
Reinsurance assets	4	57	337	264	653				54		1,369
PVIF <sup>5</sup>									1,965		1,965
Other assets and investment properties	65	2	30	104	193	399	46	52	1,196		2,087
<b>Total assets</b>	<b>9,909</b>	<b>6,430</b>	<b>3,326</b>	<b>1,971</b>	<b>3,245</b>	<b>18,995</b>	<b>13,437</b>	<b>3,905</b>	<b>10,694</b>		<b>71,912</b>
Liabilities under investment contracts designated at fair value							12,725	3,328			16,053
								312			312

Liabilities  
under  
investment  
contracts  
carried at  
amortised  
cost

Liabilities under insurance contracts	<b>9,660</b>	<b>6,399</b>	<b>3,127</b>	<b>1,583</b>	<b>2,854</b>	<b>18,983</b>	□	□	□	<b>42,606</b>
Deferred tax	□	7	3	22	3	□	6	□	582	623
Other liabilities	□	□	□	□	□	□	□	□	3,888	3,888
<b>Total liabilities</b>	<b>9,660</b>	<b>6,406</b>	<b>3,130</b>	<b>1,605</b>	<b>2,857</b>	<b>18,983</b>	<b>12,731</b>	<b>3,640</b>	<b>4,470</b>	<b>63,482</b>
Total equity	□	□	□	□	□	□	□	□	8,430	8,430
<b>Total equity and liabilities<sup>6</sup></b>	<b>9,660</b>	<b>6,406</b>	<b>3,130</b>	<b>1,605</b>	<b>2,857</b>	<b>18,983</b>	<b>12,731</b>	<b>3,640</b>	<b>12,900</b>	<b>71,912</b>

*For  
footnotes,  
see page  
269.*

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Contracts	Insurance contracts					Investment contracts				Total US\$m
	with DPF <sup>1</sup> US\$m	Unit-linked US\$m	Annuities US\$m	Term assurance <sup>2</sup> US\$m	Non-life US\$m	Unit-linked US\$m	Other US\$m	Other assets <sup>4</sup> US\$m		
At 31 December 2006										
Financial assets:										
□ trading assets					117			39		156
□ financial assets designated at fair value	1,418	2,998	366	950	94	10,041	1,597	974		18,438
□ derivatives	96	417				363	3			879
□ financial investments	3,842		1,223	390	1,554		1,441	2,173		10,623
□ other financial assets	794	52	719	138	712	222	428	632		3,697
<b>Total financial assets</b>	<b>6,150</b>	<b>3,467</b>	<b>2,308</b>	<b>1,478</b>	<b>2,477</b>	<b>10,626</b>	<b>3,469</b>	<b>3,818</b>		<b>33,793</b>
Reinsurance assets	2	58	271	773	665			48		1,817
PVIF <sup>5</sup>								1,549		1,549
Other assets and investment properties	538	203	395	356	215	154	204	614		2,679
<b>Total assets</b>	<b>6,690</b>	<b>3,728</b>	<b>2,974</b>	<b>2,607</b>	<b>3,357</b>	<b>10,780</b>	<b>3,673</b>	<b>6,029</b>		<b>39,838</b>
Liabilities under investment contracts designated at fair value						10,003	3,275			13,278
Liabilities under investment contracts carried at amortised cost							216			216
Liabilities under insurance contracts	6,389	3,685	2,773	1,864	2,939		20			17,670
Deferred tax								403		403
Other liabilities								2,322		2,322
<b>Total liabilities</b>	<b>6,389</b>	<b>3,685</b>	<b>2,773</b>	<b>1,864</b>	<b>2,939</b>	<b>10,003</b>	<b>3,511</b>	<b>2,725</b>		<b>33,889</b>
Total equity								5,949		5,949
<b>Total equity and liabilities<sup>7</sup></b>	<b>6,389</b>	<b>3,685</b>	<b>2,773</b>	<b>1,864</b>	<b>2,939</b>	<b>10,003</b>	<b>3,511</b>	<b>8,674</b>		<b>39,838</b>

1 Discretionary participation features.

2 Term assurance includes credit life insurance.

3 New category disclosed following HSBC's acquisition of HSBC Assurances. Although investment contracts with DPF are financial investments, HSBC continues to account for them as insurance contracts as permitted by IFRS 4.

4 Other assets comprise shareholder assets.

5 Present value of in-force long-term insurance contracts and investment contracts with DPF.

- 6 *Does not include assets, liabilities and shareholders' funds of associated insurance company, Ping An Insurance .*
- 7 *Does not include assets, liabilities and shareholders' funds of associated insurance companies , HSBC Assurances and Ping An Insurance.*

A principal tool used to manage the Group's exposure to insurance risk, in particular for life insurance contracts, is asset and liability matching. Models are used to assess the effect of a range of future scenarios on the values of financial assets and associated liabilities, and ALCOs employ the outcomes in determining how the assets and liabilities should be matched. The stresses applied include factors which impact on insurance risk such as mortality and lapse rates. Of particular importance is the need to match the expected pattern of cash

inflows with the benefits payable on the underlying contracts which, in some cases, can extend for many years. The table above shows the composition of assets and liabilities and demonstrates that there was an appropriate level of matching at the end of 2007. It may not always be possible to achieve a complete matching of asset and liability durations, partly because there is uncertainty over the receipt of all future premiums and partly because the duration of liabilities may exceed the duration of the longest available dated fixed interest investments.

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HSBC HOLDINGS PLC

**Report of the Directors: The Management of Risk** (continued)*Insurance operations > Financial risks***Balance sheet of insurance manufacturing subsidiaries by geographical region***(Audited)*

	Europe US\$m	Hong Kong US\$m	Rest of Asia- Pacific US\$m	North America US\$m	Latin America US\$m	Total US\$m
<b>At 31 December 2007</b>						
Financial assets:						
☐ trading assets	☐	☐	☐	☐	94	94
☐ financial assets designated at fair value	22,824	6,733	796	☐	3,360	33,713
☐ derivatives	410	5	☐	1	☐	416
☐ financial investments	13,805	6,251	78	2,425	1,393	23,952
☐ other financial assets	3,345	3,259	197	653	862	8,316
<b>Total financial assets</b>	<b>40,384</b>	<b>16,248</b>	<b>1,071</b>	<b>3,079</b>	<b>5,709</b>	<b>66,491</b>
Reinsurance assets	1,095	48	28	83	115	1,369
PVIF <sup>1</sup>	892	810	65	☐	198	1,965
Other assets and investment properties	787	926	7	52	315	2,087
<b>Total assets</b>	<b>43,158</b>	<b>18,032</b>	<b>1,171</b>	<b>3,214</b>	<b>6,337</b>	<b>71,912</b>
Liabilities under investment contracts designated at fair value	11,720	4,285	48	☐	☐	16,053
Liabilities under investment contracts carried at amortised cost	☐	☐	☐	☐	312	312
Liabilities under insurance contracts	24,788	10,843	903	1,652	4,420	42,606
Deferred tax	371	143	12	☐	97	623
Other liabilities	3,392	193	28	18	257	3,888
<b>Total liabilities</b>	<b>40,271</b>	<b>15,464</b>	<b>991</b>	<b>1,670</b>	<b>5,086</b>	<b>63,482</b>
<b>Total equity</b>	<b>2,887</b>	<b>2,568</b>	<b>180</b>	<b>1,544</b>	<b>1,251</b>	<b>8,430</b>
<b>Total equity and liabilities<sup>2</sup></b>	<b>43,158</b>	<b>18,032</b>	<b>1,171</b>	<b>3,214</b>	<b>6,337</b>	<b>71,912</b>

**At 31 December 2006**

Financial assets:

☐ trading assets	☐	☐	☐	☐	156	156
☐ financial assets designated at fair value	11,750	4,120	733	☐	1,835	18,438
☐ derivatives	720	159	☐	☐	☐	879
☐ financial investments	1,190	5,621	67	2,433	1,312	10,623
☐ other financial assets	689	1,312	108	940	648	3,697
<b>Total financial assets</b>	<b>14,349</b>	<b>11,212</b>	<b>908</b>	<b>3,373</b>	<b>3,951</b>	<b>33,793</b>

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Reinsurance assets	1,560	47	25	93	92	1,817
PVIF <sup>1</sup>	798	697	54	□	□	1,549
Other assets and investment properties	619	1,297	34	273	456	2,679
<b>Total assets</b>	<b>17,326</b>	<b>13,253</b>	<b>1,021</b>	<b>3,739</b>	<b>4,499</b>	<b>39,838</b>
Liabilities under investment contracts designated at fair value	9,069	4,164	45	□	□	13,278
Liabilities under investment contracts carried at amortised cost	□	□	□	□	216	216
Liabilities under insurance contracts	4,624	7,084	790	2,010	3,162	17,670
Deferred tax	251	123	10	□	19	403
Other liabilities	1,475	337	20	195	295	2,322
<b>Total liabilities</b>	<b>15,419</b>	<b>11,708</b>	<b>865</b>	<b>2,205</b>	<b>3,692</b>	<b>33,889</b>
<b>Total equity</b>	<b>1,907</b>	<b>1,545</b>	<b>156</b>	<b>1,534</b>	<b>807</b>	<b>5,949</b>
<b>Total equity and liabilities<sup>3</sup></b>	<b>17,326</b>	<b>13,253</b>	<b>1,021</b>	<b>3,739</b>	<b>4,499</b>	<b>39,838</b>

1 Present value of in-force long-term insurance contracts and investment contracts with DPF.

2 Does not include assets, liabilities and shareholders' funds of associated insurance company, Ping An Insurance.

3 Does not include assets, liabilities and shareholders' funds of associated insurance companies, HSBC Assurances and Ping An Insurance.

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Financial risks  
(Audited)

HSBC's insurance businesses are exposed to a range of financial risks, including market risk, credit risk and liquidity risk. Market risk includes interest rate risk, equity risk and foreign exchange risk. The nature and management of these risks is described below.

Manufacturing subsidiaries are exposed to financial risk, for example, when the proceeds from financial assets are not sufficient to fund the obligations arising from non-linked insurance and investment contracts. Certain insurance-related activities undertaken by HSBC subsidiaries such as insurance broking, insurance management (including captive management) and insurance, pensions and annuities administration and intermediation, are exposed to financial risk, but not to a significant extent.

In addition to policies provided for Group-wide application through the Group Instruction Manuals, insurance manufacturing subsidiaries may implement additional risk management procedures which reflect local market conditions and regulatory requirements.

In many jurisdictions, local regulatory requirements prescribe the type, quality and concentration of assets that HSBC's insurance manufacturing subsidiaries must maintain to meet insurance liabilities. Within each subsidiary, ALCOs are responsible for ensuring that exposures to financial risks remain within local requirements and risk mandates (as agreed with Group Insurance Head Office), and ensure compliance with the control framework established centrally through the Group Instruction Manuals.

The following table analyses the assets held in HSBC's insurance manufacturing subsidiaries at 31 December 2007 by type of liability, and provides a view of the exposure to financial risk:

**Financial assets held by insurance manufacturing subsidiaries**

(Audited)

	<b>At 31 December 2007</b>				
	<b>Life linked contracts<sup>1</sup> US\$m</b>	<b>Life non-linked contracts<sup>2</sup> US\$m</b>	<b>Non-life insurance<sup>3</sup> US\$m</b>	<b>Other assets<sup>4</sup> US\$m</b>	<b>Total US\$m</b>
<b>Trading assets</b>					
Debt securities	0	37	22	35	94
<b>Financial assets designated at fair value</b>					
Treasury bills	51	0	96	34	181
Debt securities	7,741	3,591	28	2,272	13,632
Equity securities	10,386	8,822	6	686	19,900
	<b>18,178</b>	<b>12,413</b>	<b>130</b>	<b>2,992</b>	<b>33,713</b>
<b>Financial investments</b>					
Held-to-maturity:					
Treasury bills	0	0	0	0	0
Debt securities	0	6,253	144	408	6,805



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	□	<b>6,253</b>	<b>144</b>	<b>408</b>	<b>6,805</b>
Available-for-sale:					
Treasury bills	□	<b>2</b>	<b>126</b>	<b>130</b>	<b>258</b>
Other eligible bills	□	□	<b>176</b>	<b>172</b>	<b>348</b>
Debt securities	□	<b>13,677</b>	<b>563</b>	<b>2,065</b>	<b>16,305</b>
Equity securities	□	<b>10</b>	<b>62</b>	<b>164</b>	<b>236</b>
	□	<b>13,689</b>	<b>927</b>	<b>2,531</b>	<b>17,147</b>
Derivatives		<b>302</b>	<b>83</b>	<b>1</b>	<b>30</b>
Other financial assets <sup>7</sup>		<b>1,282</b>	<b>4,376</b>	<b>1,175</b>	<b>1,483</b>
		<b>19,762</b>	<b>36,851</b>	<b>2,399</b>	<b>7,479</b>
		<b>66,491</b>			

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HSBC HOLDINGS PLC

**Report of the Directors: The Management of Risk** (continued)*Insurance operations > Financial risks > Market risk*

At 31 December 2006

	Life linked contracts <sup>1</sup> US\$m	Life non-linked contracts <sup>2</sup> US\$m	Non-life insurance <sup>3</sup> US\$m	Other assets <sup>4</sup> US\$m	Total <sup>6</sup> US\$m
<b>Trading assets</b>					
Debt securities	□	□	117	39	156
<b>Financial assets designated at fair value</b>					
Treasury bills	54	24	55	□	133
Debt securities	4,304	2,492	32	934	7,762
Equity securities	8,681	1,815	7	40	10,543
	<u>13,039</u>	<u>4,331</u>	<u>94</u>	<u>974</u>	<u>18,438</u>
<b>Financial investments</b>					
<b>Held-to-maturity:</b>					
Treasury bills	□	□	44	□	44
Debt securities	□	5,585	279	333	6,197
	<u>□</u>	<u>5,585</u>	<u>323</u>	<u>333</u>	<u>6,241</u>
<b>Available-for-sale:</b>					
Treasury bills	□	14	102	141	257
Other eligible bills	□	□	355	145	500
Debt securities	□	1,284	738	1,415	3,437
Equity securities	□	13	36	139	188
	<u>□</u>	<u>1,311</u>	<u>1,231</u>	<u>1,840</u>	<u>4,382</u>
Derivatives	780	99	□	□	879
Other financial assets <sup>7</sup>	274	2,079	712	632	3,697
	<u>14,093</u>	<u>13,405</u>	<u>2,477</u>	<u>3,818</u>	<u>33,793</u>

1 Comprises life linked insurance contracts and linked long-term investment contracts.

2 Comprises life non-linked insurance contracts and non-linked long-term investment contracts.

3 Comprises non-life insurance contracts.

4 Comprises shareholder assets.

5 Do not include financial assets of insurance manufacturing associate, Ping An Insurance.

6 Do not include financial assets of insurance manufacturing associates, HSBC Assurances and Ping An Insurance.

7 Comprises mainly loans and advances to banks, cash and intercompany balances with other non-insurance legal entities.

The table demonstrates that for linked contracts, HSBC typically designates assets at fair value. For non-linked contracts, the classification of the assets is driven by the nature of the underlying contract.

The table also shows that approximately 55.4 per cent of financial assets was invested in debt securities at 31 December 2007 (2006: 51.9 per cent) with 30.3 per cent (2006: 31.8 per cent) invested in equity securities.

In life linked insurance, premium income less charges levied is invested in a portfolio of assets. HSBC manages the financial risk of this product on behalf of the policyholders by holding appropriate assets in segregated funds or portfolios to which the liabilities are linked. HSBC typically retains some exposure to market risk as the market value of the linked assets influences the fees charged by HSBC and thereby affects the recoverability of expenses incurred by the Group in managing the product. The assets held to support life linked liabilities represented 29.7 per cent of the total financial assets of HSBC's insurance manufacturing subsidiaries at the end of 2007 (2006: 41.7 per cent).

Market risk  
(Audited)

Insurance and investment products manufactured by HSBC's insurance manufacturing subsidiaries typically comprise features or combinations of features which may not be easily or exactly replicated by investments. Market risk arises from the mismatch between product liabilities and the investment assets which back them. For example, interest rate risk arises from the mismatch between asset and liability yields and maturities.

**Description of market risks**  
(Audited)

The main features of products manufactured by HSBC's insurance manufacturing subsidiaries which generate market risks, and the market risks to which these features expose the subsidiaries, are discussed in the sections which follow.

Long-term insurance or investment products may incorporate investment return guarantees, divided into the following categories:

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- annuities in payment;
- deferred annuities: these consist of two phases – the savings and investing phase, and the retirement income phase;
- annual return: the annual return is guaranteed to be no lower than a specified rate. This may be the return credited to the policyholder every year, or the average annual return credited to the policyholder over the life of the policy, which may occur on the maturity date or the surrender date of the contract;
- capital: policyholders are guaranteed to receive no less than the premiums paid plus declared bonuses less expenses; and
- market performance: policyholders receive an investment return which is guaranteed to be within a prescribed range of average investment returns earned by predetermined market participants on the specified product.

Subsidiaries manufacturing products with guarantees are usually exposed to falls in market interest rates as these result in lower yields on the assets supporting guaranteed investment returns payable to policyholders.

The table below shows, in respect of each category of guarantee, the total policyholders' liabilities established for guaranteed products, the range of investment returns (net of operating costs) implied by the guarantees, and the range of current yields of the investment portfolios supporting the guarantees.

*Liabilities to policyholders  
(Audited)*

	2007			2006		
	Liabilities to policyholders US\$m	Investment returns implied by guarantee <sup>1</sup> %	Current yields %	Liabilities to policyholders US\$m	Investment returns implied by guarantee <sup>2</sup> %	Current yields %
Annuities in payment	716	0.0 – 8.5	5.1 – 18.1	1,240	0.0 – 7.0	5.2 – 18.6
Deferred annuities	116	0.0 – 6.0	3.8 – 8.6	420	0.0 – 6.0	3.9 – 8.6
Deferred annuities	609	6.0 – 9.0	5.7	640	6.0 – 9.0	5.7
Annual return	12,875	0.0 – 4.5	3.2 – 8.7	6,379	0.0 – 3.0	3.3 – 4.5
Annual return	352	4.5 – 6.0	3.2 – 8.5	508	3.0 – 6.0	3.8 – 7.9
Capital	11,311	0.0	3.8 – 4.8	1,196	0.0	2.9 – 4.1
Market performance <sup>3</sup>	3,605	n/a	n/a	3,723	n/a	n/a

1 Excluding guarantees from associate insurance company Ping An Insurance.

2 Excluding guarantees from associate insurance companies, HSBC Assurances and Ping An Insurance.

3 There is no specific investment return implied by market performance guarantees because the guarantees are expressed as lying within prescribed ranges of average market returns.

A certain number of these products have been discontinued, including the US\$609 million deferred annuity portfolio in HSBC Finance where, as highlighted in the above table, the current portfolio yield is less than the guarantee. On acquisition of this block of business by HSBC Finance, a provision was established to mitigate the shortfall in yields. There has been no further deterioration in the shortfall since acquisition. There are a limited number of additional contracts where the current portfolio yield is less than the guarantee implied by the contract.

Long-term insurance and investment products typically permit the policyholder to surrender the policy or let it lapse at any time. When the surrender value is not linked to the value realised from the sale of the associated supporting assets, the subsidiary is exposed to market risk. In particular, when asset values fall and customers seek to surrender their

policies, assets may have to be sold at a loss to fund redemptions.

Insurance and investment products with DPF are primarily invested in bonds, but a proportion of their investment portfolios is allocated to equity securities in order to provide customers with potentially enhanced returns. Subsidiaries with portfolios of such products are exposed to falls in the market price of equity securities when the risk cannot be managed through the discretionary bonus policy.

A subsidiary holding a portfolio of long-term insurance and investment products, especially with DPF, may attempt to reduce exposure to one particular market by investing in assets in countries other than the country in which it is based. These assets may be denominated in currencies other than the subsidiary's local currency. It is often not cost effective to hedge the foreign exchange exposure of

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HSBC HOLDINGS PLC

## **Report of the Directors: The Management of Risk** (continued)

*Insurance operations > Financial risks > Market risk / Credit risk*

these assets and the subsidiary will be exposed to a strengthening of its local currency against the currency of the related assets.

For unit-linked contracts, market risk is substantially borne by the policyholder. HSBC typically retains an exposure to market risk as the market value of the linked assets influences the fees HSBC earns for managing them.

### **How the risks are managed**

*(Audited)*

HSBC's insurance manufacturing subsidiaries manage market risk by using some or all of the techniques relevant to the contracts being written by the subsidiary. The techniques applied may include:

- for products with DPF, adjusting bonus rates to manage the liabilities to policyholders. The management of bonus rates is achieved by regularly evaluating their sustainability. In practice, this means that a portion of the market risk is borne by the policyholder;
- as far as possible, matching assets to liabilities. For example, for products with annual return or capital guarantees, HSBC invests in bonds which produce a return at least equal to the investment return implied by the guarantee;
- using derivatives, in a limited number of instances;
- when designing new products with investment guarantees, evaluating the cost of the guarantee and considering this cost when determining the premium level or the price structure;
- including features designed to mitigate market risk in new products, for example, surrender penalty charges to recoup losses incurred when policyholders surrender their policies; and
- exiting investment portfolios when the level of risk is no longer acceptable.

Each insurance manufacturing subsidiary is required to have a market risk mandate which specifies the investment instruments in which it is permitted to invest and the maximum quantum of market risk which it is permitted to retain. It is the responsibility of the local ALCO to ensure that its mandate is consistent with local regulations. All mandates must be reviewed and agreed annually with Group Insurance Head Office, and aggregate limits are approved by the Risk Management Meeting of the Group Management Board.

### **How the exposures to risks are measured**

*(Audited)*

HSBC's insurance manufacturing subsidiaries monitor exposures against mandated limits regularly and report these quarterly to Group Insurance Head Office. Exposures are aggregated and reported to senior risk management forums in the Group, including the Group Insurance Market and Liquidity Risk Meeting, Group Insurance Risk Committee and the Group Stress Test Review Group.

The standard measures used to quantify the market risks are as follows:

-

for interest rate risk, the sensitivities of the net present values of asset and expected liability cash flows, in total and by currency, to a one basis point parallel upward shift in the discount curves used to calculate the net present values;

- for equity price risk, the total market value of equity holdings and the market value of equity holdings by region and country; and
- for foreign exchange rate risk, the total net short foreign exchange position and the net foreign exchange positions by currency.

Although these measures are relatively straightforward to calculate and aggregate, there are limitations. The most significant limitation is that the one basis point parallel shift in yield curves measure does not capture the non-linear relationships between the value of certain assets and liabilities and interest rates which arise, for example, from investment return guarantees, and certain product features such as the ability of policyholders to surrender their policies. If the yields on investments held to support contracts with guarantees are below the investment return implied by the guarantee, shortfalls will fall to the account of HSBC.

HSBC recognises these limitations and augments its standard measures with stress tests which examine the effect of a range of market rate scenarios on the aggregated profits of the insurance manufacturing subsidiaries for the year and their net assets. A quarterly process was introduced for HSBC's insurance manufacturing subsidiaries during 2007 to report stress tests to Group Insurance Head Office, where the reports are consolidated and reviewed by the Group Insurance Market and Liquidity Risk Meeting and the Group Stress Test Review Group.

HSBC's insurance manufacturing subsidiaries identify those assets and liabilities whose values in the financial statements are sensitive to each category of market risk and revalue them assuming different market rates. The outcome of the exercise

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is measured in terms of the change in profit after tax and net assets under the stress-tested assumptions, after taking into consideration tax and accounting treatments where material and relevant.

The following table illustrates the effect on the aggregated profit for the year and net assets under various interest rate, equity price, foreign exchange rate and credit spread scenarios. Where appropriate, the impact of the stress on the PVIF is included in

the results of the stress tests. The relationship between the value of certain assets and liabilities and the risk factors may be non-linear and, therefore, the results disclosed cannot be extrapolated to measure sensitivities to different levels of stress. The sensitivities are stated before allowance for the effect of management actions which may mitigate changes in market rates, and for any factors such as policyholder behaviour that may change in response to changes in market risk.

### Sensitivity of HSBC's insurance subsidiaries to risk factors

(Audited)

	2007		2006	
	Impact on profit for the year US\$m	Impact on net assets US\$m	Impact on profit for the year US\$m	Impact on net assets US\$m
+ 100 basis points parallel shift in yield curves	67	(29)	(13)	(111)
□ 100 basis points parallel shift in yield curves	(71)	49	24	103
10 per cent increase in equity prices	147	151	93	95
10 per cent decrease in equity prices	(145)	(149)	(86)	(87)
10 per cent increase in US dollar exchange rate compared to all currencies	12	12	(10)	(10)
10 per cent decrease in US dollar exchange rate compared to all currencies	(12)	(12)	10	10
Sensitivity to credit spread increases	(15)	(30)	(7)	(12)

The sensitivity of the net profit of HSBC's insurance subsidiaries to the effects of increases in credit spreads is a fall of US\$15 million (2006: US\$7 million fall). The sensitivity is expressed on an after tax basis consistent with the other sensitivities noted above and has been calculated using simplified assumptions based on one-day movement in credit spreads over a two-year period. A confidence level of 99 per cent, consistent with the Group's VAR, has been applied. The impact of movements in credit spreads has become more significant in 2007 due to increased volatility in credit spreads.

#### Credit risk

(Audited)

Credit risk can give rise to losses through default and can lead to volatility in income statement and balance sheet figures through movements in credit spreads, principally on the US\$29.8 billion (2006: US\$14.1 billion) non-linked bond portfolio. The exposure of the income statement to the effect of changes in credit spreads is small (see the table above). 36 per cent of the financial assets held by insurance subsidiaries are classified as either held to maturity or available for sale, and consequently any changes in the fair value of these financial investments would have no impact on the profit after tax.



HSBC's exposure to credit risk in its insurance manufacturing subsidiaries primarily arises from their portfolios of invested assets held, their reinsurance transactions and any credit protection products they write.

HSBC sells certain unit-linked life insurance contracts via a co-insurance agreement with a third party. The insurance contracts issued under the co-insurance agreement include market return guarantees, which are underwritten by the third party. HSBC has a credit risk exposure arising on the guarantees were the counterparty unable to meet the terms of the guarantees. At 31 December 2007, the exposure to the counterparty was small.

The exposure to credit risk products and the management of the risks associated with credit protection products are included in the analyses of life and non-life insurance risk from page 266 to 267.

Management of HSBC's insurance manufacturing subsidiaries is responsible for the credit risk, quality and performance of their investment portfolios. Investment credit mandates and limits are set locally by the insurance manufacturing subsidiaries and approved by their local insurance ALCO and Credit Risk function before receiving concurrence centrally from Group Credit Risk. The form and content of the mandates

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HSBC HOLDINGS PLC

**Report of the Directors: The Management of Risk** (continued)*Insurance operations > Financial risks > Credit risk*

accord with centrally set investment credit risk guidance regarding credit quality, industry sector concentration and liquidity restrictions, but allow for local regulatory and country-specific conditions. The assessment of creditworthiness of issuers and counterparties is based primarily upon internationally recognised credit ratings and other publicly available information.

Investment credit exposures are monitored against limits by the local insurance manufacturing subsidiaries, and are aggregated and reported to HSBC's Group Credit Risk function, the Group Insurance Credit Risk Meeting and the Group Insurance Risk Committee.

Stress testing is performed by Group Insurance Head Office on the investment credit exposures using credit spread sensitivities and default

probabilities. The stresses are reported to the Group Insurance Credit Risk Committee.

**Credit quality***(Audited)*

The following table presents the analysis of treasury bills, other eligible bills and debt securities within HSBC's insurance business by rating agency designation based on Standard & Poor's ratings or equivalent. Only assets supporting non-linked liabilities are included in the table since financial risk on assets supporting linked liabilities is predominantly borne by the policyholder.

The table indicates that 72.3 per cent (2006: 74.5 per cent) of the assets included in the table are invested in AA or AAA rated investments.

*Treasury bills, other eligible bills and debt securities in HSBC's insurance subsidiaries (Audited)*

	<b>Treasury bills US\$m</b>	<b>Other eligible bills US\$m</b>	<b>Debt securities US\$m</b>	<b>Total US\$m</b>
<b>At 31 December 2007</b>				
Supporting liabilities under non-linked insurance and investment contracts				
AAA	114	63	8,819	8,996
AA <sup>+</sup> to AA+	□	113	8,876	8,989
A <sup>+</sup> to A+	□	□	4,115	4,115
Lower than A <sup>+</sup>	96	□	2,211	2,307
Unrated	14	□	294	308
	<b>224</b>	<b>176</b>	<b>24,315</b>	<b>24,715</b>

## Supporting shareholders' funds

AAA	118	165	2,082	2,365
AA□ to AA+	□	7	1,212	1,219
A□ to A+	□	□	786	786
Lower than A□	39	□	632	671
Unrated	7	□	68	75
	<b>164</b>	<b>172</b>	<b>4,780</b>	<b>5,116</b>

Total<sup>2</sup>

AAA	232	228	10,901	11,361
AA□ to AA+	□	120	10,088	10,208
A□ to A+	□	□	4,901	4,901
Lower than A□	135	□	2,843	2,978
Unrated	21	□	362	383
	<b>388</b>	<b>348</b>	<b>29,095</b>	<b>29,831</b>

## Of which issued by:

□ governments	388	□	7,140	7,528
□ local authorities	□	□	175	175
□ asset-backed securities	□	□	201	201
□ corporates and other	□	348	21,579	21,927
	<b>388</b>	<b>348</b>	<b>29,095</b>	<b>29,831</b>

## Of which classified as:

□ trading assets	□	□	94	94
□ financial instruments designated at fair value	130	□	5,891	6,021
□ available-for-sale securities	258	348	16,305	16,911
□ held-to-maturity investments	□	□	6,805	6,805
	<b>388</b>	<b>348</b>	<b>29,095</b>	<b>29,831</b>

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(Audited)	Treasury bills US\$m	Other eligible bills US\$m	Debt securities US\$m	Total US\$m
At 31 December 2006				
Supporting liabilities under non-linked insurance and investment contracts				
AAA	217	145	3,876	4,238
AA□ to AA+	□	210	3,994	4,204
A□ to A+	□	□	1,880	1,880
Lower than A□	□	□	667	667
Unrated	22	□	110	132
	<u>239</u>	<u>355</u>	<u>10,527</u>	<u>11,121</u>
Supporting shareholders□ funds				
AAA	119	137	918	1,174
AA□ to AA+	□	8	903	911
A□ to A+	□	□	692	692
Lower than A□	21	□	180	201
Unrated	1	□	28	29
	<u>141</u>	<u>145</u>	<u>2,721</u>	<u>3,007</u>
Total <sup>3</sup>				
AAA	336	282	4,794	5,412
AA□ to AA+	□	218	4,897	5,115
A□ to A+	□	□	2,572	2,572
Lower than A□	21	□	847	868
Unrated	23	□	138	161
	<u>380</u>	<u>500</u>	<u>13,248</u>	<u>14,128</u>
Of which issued by:				
□ governments	380	□	2,825	3,205
□ local authorities	□	□	69	69
□ asset-backed securities	□	□	223	223
□ corporates and other	□	500	10,131	10,631
	<u>380</u>	<u>500</u>	<u>13,248</u>	<u>14,128</u>
Of which classified as:				
□ trading assets	□	□	156	156
□ financial instruments designated at fair value	79	□	3,458	3,537
□ available-for-sale securities	257	500	3,437	4,194
□ held-to-maturity investments	44	□	6,197	6,241
	<u>380</u>	<u>500</u>	<u>13,248</u>	<u>14,128</u>

1 Shareholders□ funds comprise solvency and unencumbered assets.

2 Does not include treasury bills, other eligible bills and debt securities held by insurance manufacturing associate, Ping An Insurance.

3 Does not include treasury bills, other eligible bills and debt securities held by insurance manufacturing associates, HSBC Assurances and Ping An Insurance.

*(Audited)*

Credit risk also arises when part of the insurance risk incurred by HSBC is assumed by reinsurers. The credit risk exposure for reinsurers is monitored by Group Insurance Head Office and is reported quarterly to the Group Insurance Risk Committee and the Group Insurance Credit Risk Committee.

The split of liabilities ceded to reinsurers and outstanding reinsurance recoveries, analysed by Standard & Poor's reinsurance credit rating data or their equivalent, was as follows:

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HSBC HOLDINGS PLC

**Report of the Directors: The Management of Risk** (continued)*Insurance operations > Financial risks > Liquidity risk**Reinsurance  
(Audited)***Reinsurers' share of liabilities  
under  
insurance contracts**

	Linked insurance contracts US\$m	Non-linked insurance contracts US\$m	Total US\$m	Reinsurance debtors US\$m
<b>At 31 December 2007</b>				
AAA	7	33	40	1
AA□ to AA	28	297	325	26
A□ to A+	□	669	669	16
Lower than A□	22	10	32	2
Unrated	□	249	249	9
<b>Total<sup>1</sup></b>	<b>57</b>	<b>1,258</b>	<b>1,315</b>	<b>54</b>
<b>At 31 December 2006</b>				
AAA	10	106	116	□
AA□ to AA	33	812	845	37
A□ to A+	□	586	586	5
Lower than A□	15	37	52	3
Unrated	□	170	170	3
<b>Total<sup>2</sup></b>	<b>58</b>	<b>1,711</b>	<b>1,769</b>	<b>48</b>

1 Does not include reinsurers' share of liabilities under insurance contracts and reinsurance debtors of insurance manufacturing associate, Ping An Insurance.

2 Does not include reinsurers' share of liabilities under insurance contracts and reinsurance debtors of insurance manufacturing associates, HSBC Assurances and Ping An Insurance.

*Liquidity risk  
(Audited)*

It is an inherent characteristic of almost all insurance contracts that there is uncertainty over the amount and the timing of settlement of claims liabilities that may arise, and this leads to liquidity risk.

To fund the cash outflows arising from claims liabilities, HSBC's insurance manufacturing subsidiaries utilise liquidity primarily from the following sources:

- cash inflows arising from premiums from new business, policy renewals and recurring premium products;

- cash inflows arising from interest and dividends on investments and principal repayments of maturing debt investments;
- cash resources; and
- cash inflows from the sale of investments.

HSBC's insurance manufacturing subsidiaries manage liquidity risk by utilising some or all of the following techniques:

- matching cash inflows with expected cash outflows using specific cash flow projections or more general asset and liability matching techniques such as duration matching;
- maintaining sufficient cash resources;
- investing in good credit-quality investments with deep and liquid markets to the degree to which they exist;
- monitoring investment concentrations and restricting them where appropriate, for example, debt issues or issuers; and
- establishing committed contingency borrowing facilities.

During 2007, a quarterly process has been introduced whereby HSBC's insurance manufacturing subsidiaries are required to complete and submit liquidity risk reports to Group Insurance Head Office for collation and review by the Group Insurance Market and Liquidity Risk Meeting. Liquidity risk is assessed in these reports by measuring changes in expected cumulative net cash flows under a series of stress scenarios designed to determine the effect of reducing expected available liquidity and accelerating cash outflows. This is achieved by, for example, assuming new business or renewals are lower, and surrenders or lapses are greater than expected.

As indicated in the table headed "Expected maturity of insurance contract liabilities" below and in the analyses of life and non-life insurance risks on pages 266 to 267, a significant proportion of the Group's non-life insurance business is viewed as short term, with the settlement of liabilities expected to occur within one year of the period of risk. There is a greater spread of expected maturities for the life business where, in a large proportion of cases, the

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liquidity risk is borne in conjunction with policyholders (wholly in the case of unit-linked business).

The following tables show the expected undiscounted cash flows for insurance contract liabilities and the remaining contractual maturity of investment contract liabilities, respectively, at 31 December 2007.

The profile of the expected maturity of the insurance contracts as at 31 December 2007 has remained stable compared with 2006. The increase in the undated investment contract liabilities arises principally from the incorporation of HSBC Assurances' balance sheet as a subsidiary at 31 December 2007.

*Expected maturity of insurance contract liabilities  
(Audited)*

	<b>Expected cash flows (undiscounted)</b>				
	<b>Within 1 year US\$m</b>	<b>1-5 years US\$m</b>	<b>5-15 years US\$m</b>	<b>Over 15 years US\$m</b>	<b>Total US\$m</b>
<b>At 31 December 2007<sup>1</sup></b>					
Non-life insurance	1,337	1,352	164	1	2,854
Life insurance (non-linked)	1,887	5,310	15,986	13,269	36,452
Life insurance (linked)	507	1,894	3,644	5,014	11,059
	<b>3,731</b>	<b>8,556</b>	<b>19,794</b>	<b>18,284</b>	<b>50,365</b>
<b>At 31 December 2006<sup>2,3</sup></b>					
Non-life insurance	1,679	1,136	118	6	2,939
Life insurance (non-linked)	1,096	4,190	13,455	12,646	31,387
Life insurance (linked)	337	1,162	2,071	2,099	5,669
	<b>3,112</b>	<b>6,488</b>	<b>15,644</b>	<b>14,751</b>	<b>39,995</b>

1 Does not include investment contracts by insurance manufacturing associate, Ping An Insurance.

2 2006 balances for life insurance have been restated to ensure a consistent presentation with 2007 balances for this disclosure.

3 Does not include investment contracts by insurance manufacturing associates, HSBC Assurances and Ping An Insurance.

*Remaining contractual maturity of investment contract liabilities  
(Audited)*

	<b>Liabilities under investment contracts by insurance underwriting subsidiaries</b>			
	<b>Linked investment contracts US\$m</b>	<b>Other investment contracts US\$m</b>	<b>Investment contracts with DPF US\$m</b>	<b>Total US\$m</b>
<b>At 31 December 2007<sup>1</sup></b>				
Remaining contractual maturity:				
□ due within 1 year	286	331	1	618
□ due between 1 and 5 years	1,234	48	28	1,310
□ due between 5 and 10 years	950	□	□	950



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□ due after 10 years	3,386	44	□	3,430
□ undated <sup>1</sup>	6,869	3,217	18,954	29,040
	<u>12,725</u>	<u>3,640</u>	<u>18,983</u>	<u>35,348</u>

At 31 December 2006<sup>3</sup>

Remaining contractual maturity:

□ due within 1 year	274	265	□	539
□ due between 1 and 5 years	1,238	45	20	1,303
□ due between 5 and 10 years	856	□	□	856
□ due after 10 years	3,312	□	□	3,312
□ undated <sup>2</sup>	4,323	3,181	□	7,504
	<u>10,003</u>	<u>3,491</u>	<u>20</u>	<u>13,514</u>

- 1 Does not include investment contracts by insurance manufacturing associate, Ping An Insurance.
- 2 In most cases, policyholders have the option to terminate their contracts at any time and receive the surrender values of their policies. These may be significantly lower than the amounts shown above.
- 3 Does not include investment contracts by insurance manufacturing associates, HSBC Assurances and Ping An Insurance.

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HSBC HOLDINGS PLC

**Report of the Directors: The Management of Risk** (continued)**Insurance operations > PVIF**

Present value of in-force long-term insurance business  
(Audited)

The HSBC life insurance business is accounted for using the embedded value approach, which, *inter alia*, provides a comprehensive framework for the evaluation of insurance and related risks. The present value of the in-force long-term (□PVIF□) asset at 31 December 2007 was US\$2.0 billion (2006: US\$1.5 billion). The present value of the shareholders' interest in the profits expected to emerge from the book of in-force policies at 31 December can be stress-tested to assess the ability of the life business book to withstand adverse developments. A key feature of the life insurance business is the importance of managing the assets, liabilities and risks in a coordinated fashion rather than individually. This reflects the greater interdependence of these three elements for life insurance than is generally the case for non-life insurance.

The following table shows the effect on the PVIF of reasonably possible changes in the main economic assumptions, changes in the risk-free and risk discount rates, across all insurance manufacturing subsidiaries.

It should be noted that, due to certain conditions that may exist within the contracts, the effects may be non-linear and so the results of the stress-testing

**Sensitivity of PVIF to changes in economic assumptions**  
(Audited)

	PVIF at 31 December	
	2007 US\$m	2006 US\$m
+ 100 basis points shift in risk-free rate	195	130
□ 100 basis points shift in risk-free rate	(232)	(141)
+ 100 basis points shift in risk discount rate	(95)	(64)
□ 100 basis points shift in risk discount rate	106	70

disclosed may not be extrapolated to higher levels of stress. In calculating the various scenarios, all other assumptions are held stable except for testing the effect of the shift in the risk-free rate, when consequential changes to investment returns, risk discount rates and bonus rates are also incorporated. The sensitivities shown are before actions that could be taken by management to mitigate effects and before consequential changes in policyholder behaviour.

The following table shows the movements recorded during the year in respect of PVIF and the net assets of insurance operations:

**Movements in PVIF and net assets of insurance operations**  
(Audited)

	2007			2006		
	PVIF US\$m	Net assets of insurance operations US\$m	Total US\$m	PVIF US\$m	Net assets of insurance operations US\$m	Total US\$m
At 1 January	1,549	4,400	5,949	1,400	3,582	4,982
Value of new business written during the year <sup>1</sup>	380	□	380	254	□	254
Acquisitions of subsidiaries/portfolios	390	262	652	□	□	□
Movements arising from in-force business:						
□ expected return	(175)	□	(175)	(233)	□	(233)
□ experience variances <sup>2</sup>	53	□	53	31	□	31
□ change in operating assumptions	(86)	□	(86)	(17)	□	(17)
Investment return variances	□	□	□	13	□	13
Changes in investment assumptions	4	□	4	3	□	3
Return on net assets	□	1,235	1,235	□	752	752
Disposals of subsidiaries/portfolios	□	(250)	(250)	□	□	□
Exchange differences and other	(150)	59	(91)	98	95	193
Capital transactions	□	759	759	□	(29)	(29)
At 31 December	1,965	6,465	8,430	1,549	4,400	5,949

- <sup>1</sup> Value of net new business during the year is the present value of the projected stream of profits from the business.
- <sup>2</sup> Experience variances include the effect of the difference between demographic, expense and persistency assumptions used in the previous PVIF calculation and actual experience observed during the year.

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### Non-economic assumptions (Audited)

The policyholder liabilities and PVIF are determined by reference to non-economic assumptions which include, for non-life manufacturers, claims costs and expense rates and, for life manufacturers, mortality and/or morbidity, lapse rates and expense rates. The table below shows the sensitivity of profit for the year to, and net assets at, 31 December 2007 to reasonably possible changes in these non-economic assumptions at 31 December 2007 across all insurance manufacturing subsidiaries, with comparatives for 2006.

Claims costs is a risk associated with non-life insurance business. If the cost of claims increases, a negative impact on profit would occur.

Mortality and morbidity risk is typically associated with life insurance contracts. The impact of an increase in mortality or morbidity on profit depends on the type of business being written. For a portfolio of term assurance contracts, an increase in mortality would have a negative impact on profit since the instances of claims would increase. For a portfolio of annuity contracts, an increase in

mortality rates typically has a positive impact on profit as the period over which the benefit is being paid to the policyholder is shortened. However, where an annuity contract includes life cover, the positive impact of reduced future annuity payments observed through an increase in mortality can be offset by the benefits payable under the life cover.

Sensitivity to lapse rates is dependent on the type of contracts being written. For insurance contracts, the cost of claims is funded by premiums received and income earned on the investment portfolio supporting the liabilities. For a portfolio of term assurance, an increase in lapses typically leads to a negative impact on profit due to the loss of future premium income on the lapsed policies. For a portfolio of annuity contracts, an increase in lapse rates results in a positive impact on profit as the period over which the Group is obliged to pay benefits to the policyholder is shortened.

Expense rate risk is the exposure to a change in expense rates. To the extent that increased expenses cannot be passed on to the policyholder, an increase in expense rates will have a negative impact on profits.

### Sensitivity analysis (Audited)

	Effect on profit for the year to 31 December			Effect on net assets at 31 December		
	Life US\$m	Non-life US\$m	Total US\$m	Life US\$m	Non-life US\$m	Total US\$m
<b>2007</b>						
20% increase in claims costs	□	(138)	(138)	□	(138)	(138)

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20% decrease in claims costs	□	<b>138</b>	<b>138</b>	□	<b>138</b>	<b>138</b>
10% increase in mortality and/or morbidity rates	<b>(21)</b>	□	<b>(21)</b>	<b>(21)</b>	□	<b>(21)</b>
10% decrease in mortality and/or morbidity rates	<b>9</b>	□	<b>9</b>	<b>9</b>	□	<b>9</b>
50% increase in lapse rates	<b>(16)</b>	□	<b>(16)</b>	<b>(16)</b>	□	<b>(16)</b>
50% decrease in lapse rates	<b>61</b>	□	<b>61</b>	<b>61</b>	□	<b>61</b>
10% increase in expense rates	<b>(23)</b>	<b>(6)</b>	<b>(29)</b>	<b>(23)</b>	<b>(6)</b>	<b>(29)</b>
10% decrease in expense rates	<b>23</b>	<b>6</b>	<b>29</b>	<b>23</b>	<b>6</b>	<b>29</b>
2006						
20% increase in claims costs	□	(118)	(118)	□	(118)	(118)
20% decrease in claims costs	□	118	118	□	118	118
10% increase in mortality and/or morbidity rates	(8)	□	(8)	(8)	□	(8)
10% decrease in mortality and/or morbidity rates	15	□	15	15	□	15
50% increase in lapse rates	10	□	10	10	□	10
50% decrease in lapse rates	22	□	22	22	□	22
10% increase in expense rates	(21)	(2)	(23)	(21)	(2)	(23)
10% decrease in expense rates	21	2	23	21	2	23

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HSBC HOLDINGS PLC

## **Report of the Directors: The Management of Risk** (continued)

*Capital management and allocation > Capital measurement*

### **Capital management and allocation**

Capital management  
(Audited)

HSBC's capital management approach is driven by its strategy and organisational requirements, taking into account the regulatory and commercial environment in which it operates. The Group's strategy underpins HSBC's Capital Management Framework which has been approved by the Group Management Board. It is HSBC's policy to maintain a strong capital base to support the development of its business and to meet regulatory capital requirements at all times. It also maintains a strong discipline over its investment decisions and where it allocates its capital, seeking to ensure that returns on investment are appropriate after taking account of capital costs. In addition, the level of capital held by HSBC Holdings and other major subsidiaries, particularly HSBC Finance, is determined by its rating targets.

HSBC's strategic intention is to allocate capital to businesses based on their economic profit generation and, within this process, regulatory and economic capital requirements and the cost of capital are key factors. The responsibility for global capital allocation principles and decisions rests with the Group Management Board. Stress testing is used as an important mechanism in understanding the sensitivities of the core assumptions in the capital plans to the adverse impact of extreme, but plausible, events. Stress testing allows senior management to formulate management action in advance of conditions starting to reflect the stress scenarios identified. The Group has identified the following as being the material risks faced and managed through the Capital Management Framework; credit, market, operational, asset and liability management, pension, and insurance risks.

In 2007, HSBC continued to manage its capital against its benchmark minimum tier 1 capital ratio of 8.25 per cent, which it has used under the current Basel Capital Accord (Basel I) for the purposes of its long-term capital planning. In 2008, as the Group operates under the new framework for calculating minimum capital requirements known as Basel II, it will target a tier 1 capital ratio within the range 7.5 to 9.0 per cent, based on core tier 1 capital plus innovative tier 1 capital, less deductions from tier 1 capital under the FSA's Basel II disclosure rules.

HSBC recognises the effect on shareholder returns of the level of equity capital employed within the Group and seeks to maintain a prudent balance between the advantages and flexibility afforded by a strong capital position and the higher returns on

equity that are possible with greater leverage.

The Capital Management Framework covers the different capital measures within which HSBC manages its capital in a consistent and aligned manner. These include the market capitalisation, invested capital, economic capital and regulatory capital. HSBC defines invested capital as the equity capital invested in HSBC by its shareholders. Economic capital is the capital requirement calculated internally by HSBC to support the risks to which it is exposed and is set at a confidence level consistent with a "AA" target credit rating. Regulatory capital is the capital which HSBC is required to hold as determined by the rules established by the FSA for the consolidated Group and by HSBC's local regulators for individual Group companies.

An annual Group capital plan is prepared and approved by the Board with the objective of maintaining both the optimal amount of capital and the mix between the different components of capital. The Group's policy is to hold capital in a range of different forms and from diverse sources and all capital raising is agreed with major subsidiaries as part of their individual and the Group's capital management processes. HSBC Holdings and its major subsidiaries raise non-equity tier 1 capital and subordinated debt in accordance with the Group's guidelines on market and investor concentration, cost, market conditions, timing, effect on composition and maturity profile. The subordinated debt requirements of other HSBC companies are met internally.

Each subsidiary manages its own capital required to support planned business growth and meet local regulatory requirements, within the context of the approved annual Group capital plan. As part of HSBC's Capital Management Framework, capital generated in excess of planned requirements is returned to HSBC Holdings, normally by way of dividends.

HSBC Holdings is primarily a provider of equity capital to its subsidiaries. These investments are substantially funded by HSBC Holdings' own capital issuance and profit retentions. HSBC Holdings seeks to maintain a prudent balance between the composition of its capital and that of its investment in subsidiaries.

#### Capital measurement and allocation *(Audited)*

The FSA supervises HSBC on a consolidated basis and, as such, receives information on the capital adequacy of, and sets capital requirements for,

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HSBC as a whole. Individual banking subsidiaries are directly regulated by their local banking supervisors, who set and monitor their capital adequacy requirements. In most jurisdictions, non-banking financial subsidiaries are also subject to the supervision and capital requirements of local regulatory authorities. Since 1988, when the governors of the Group of Ten central banks agreed to guidelines for the international convergence of capital measurement and standards, known as Basel I, the banking supervisors of HSBC's major banking subsidiaries have exercised capital adequacy supervision within a broadly similar framework.

The FSA implements the capital adequacy requirements issued by the Basel Committee on Banking Supervision (the Basel Committee) as implemented by the relevant EU Directives. In June 2006, the EU Capital Requirements Directive (CRD) was formally adopted by the Council and European Parliament and it required EU Member States to bring implementing provisions into force on 1 January 2007. The CRD recast the Banking Consolidation Directive and the Capital Adequacy Directive, which had previously applied.

In October 2006, the FSA published the General Prudential Sourcebook (GENPRU) and the Prudential Sourcebook for Banks, Building Societies and Investment Firms (BIPRU), which took effect from 1 January 2007 and implemented the CRD in the UK. GENPRU introduced changes to the definition of capital and the methodology for calculating a firm's capital resources requirements. BIPRU sets out the FSA's rules implementing the other CRD requirements for banks, building societies and investment firms and groups containing such firms. Transitional provisions regarding the implementation of capital requirements calculations meant that, in general, unless firms notified the FSA to the contrary, they continued to apply the existing capital requirements calculations until 1 January 2008; changes that took effect on that date are described below in the section "Basel II".

In implementing these EU Directives, the FSA requires each bank and banking group to maintain an individually prescribed ratio of total capital to risk-weighted assets, taking into account both balance sheet assets and off-balance sheet transactions.

HSBC's capital is divided into two tiers:

- Tier 1 capital comprises core tier 1 capital and innovative tier 1 securities. Core tier 1 capital comprises shareholders' funds, and minority interests in tier 1 capital, after adjusting for items reflected in shareholders' funds which are treated differently for the purposes of capital adequacy. The book values of goodwill and intangible assets are deducted in arriving at core tier 1 capital.
- Tier 2 capital comprises qualifying subordinated loan capital, collective impairment allowances, minority and other interests in tier 2 capital and unrealised gains arising on the fair valuation of equity instruments held as available-for-sale.  
Tier 2 capital also includes reserves arising from the revaluation of properties.

Various limits are applied to elements of the capital base. The amount of innovative tier 1 securities cannot exceed 15 per cent of overall tier 1 capital, qualifying tier 2 capital cannot exceed tier 1 capital, and qualifying term subordinated loan capital may not exceed 50 per cent of tier 1 capital. There are also limitations on the amount of collective impairment allowances which may be included as part of tier 2 capital. From the total of tier 1 and tier 2 capital are deducted the carrying amounts of unconsolidated investments, investments in the capital of banks, and certain regulatory items.

Changes to the definition of capital came into force on 1 January 2007. They include the introduction of proportional consolidation of banking associates, which previously were either fully consolidated or deducted from capital, the relaxation of rules covering the deduction of investments in other banks' capital, and a change for disclosure purposes only to make certain deductions, previously from total capital, now 50 per cent from each of tier 1 and tier 2 capital in the published disclosures. This applies to deductions of investments in insurance subsidiaries and associates, but the FSA has granted a transitional provision, until 31 December 2012, under which any of these insurance investments that were acquired before 20 July 2006 may be deducted from the total of tier 1 and tier 2 capital instead. HSBC has elected to apply this transitional provision.

Banking operations are categorised as either trading book or banking book and risk-weighted assets are determined accordingly. Banking book risk-weighted assets are measured by means of a hierarchy of risk



weightings classified according to the nature of each asset and counterparty, taking into account any eligible collateral or guarantees. Banking book off-balance sheet items giving rise to credit, foreign exchange or interest rate risk are assigned weights appropriate to the category of the counterparty, taking into account any eligible collateral or guarantees. Trading book risk-weighted assets are determined by taking into account market-

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HSBC HOLDINGS PLC

## Report of the Directors: The Management of Risk (continued)

### Capital management and allocation > Basel II

related risks such as foreign exchange, interest rate and equity position risks, and counterparty risk.

#### Basel II

(Audited)

The Basel Committee on Banking Supervision (the Basel Committee) has published Basel II which replaces the 1988 Basel Capital Accord. The supervisory objectives for Basel II are to promote safety and soundness in the financial system and maintain at least the current overall level of capital in the system; enhance competitive equality; constitute a more comprehensive approach to addressing risks; and focus on internationally active banks. Basel II is structured around three pillars: minimum capital requirements, supervisory review process and market discipline. The CRD is the means by which Basel II is implemented in the EU. The FSA gives effect to the CRD through GENPRU and BIPRU, as described above.

Basel II provides three approaches, of increasing sophistication, to the calculation of pillar 1 credit risk capital requirements. The most basic, the standardised approach, requires banks to use external credit ratings to determine the risk weightings applied to rated counterparties, and groups other counterparties into broad categories and applies standardised risk weightings to these categories. In the next level, the internal ratings-based (IRB) foundation approach allows banks to calculate their credit risk regulatory capital requirement on the basis of their internal assessment of the probability that a counterparty will default, but with quantification of exposure and loss estimates being subject to standard supervisory parameters. Finally, the IRB advanced approach, will allow banks to use their own internal assessment of not only the probability of default but also the quantification of exposure at default and loss given default. Expected losses are calculated by multiplying the probability of default by the loss given default multiplied by the exposure at default. The capital resources requirement under the IRB approaches is intended to cover unexpected losses and is derived from a formula specified in the regulatory rules, which incorporates these factors and other variables such as maturity and correlation.

For credit risk, with FSA approval, HSBC has adopted the IRB advanced approach to Basel II for the majority of its business with effect from 1 January 2008, with the remainder on either IRB foundation or standardised approaches. A rollout plan is in place to extend coverage of the advanced approach over the next three years, leaving a small residue of exposures on the standardised approach.

Basel II also introduces capital requirements for operational risk and, again, contains three levels of sophistication. The capital required under the basic indicator approach is a simple percentage of gross revenues, whereas under the standardised approach it is one of three different percentages of gross revenues allocated to each of eight defined business lines. Finally, the advanced measurement approach uses banks' own statistical analysis and modelling of operational risk data to determine capital requirements. HSBC has adopted the standardised approach to the determination of Group operational risk capital requirements.

The basis of calculating capital changed with effect from 1 January 2008 and the effect on both tier 1 capital and total capital is shown in the table below, Impact of Basel II. The Group's capital base is reduced compared with Basel I by the extent to which expected losses exceed the total of individual and collective impairment allowances on IRB portfolios. These collective impairment allowances are no longer eligible for inclusion in tier 2 capital.

For disclosure purposes, this excess of expected losses over total impairment allowances in IRB portfolios is deducted 50 per cent from tier 1 and 50 per cent from tier 2 capital. In addition, a tax credit adjustment is made

to tier 1 capital to reflect the tax consequences insofar as they impact on the availability of tier 1 capital to cover risks or losses.

Expected losses, derived under Basel II rules, represent losses that would be expected in the scenario of a severe downturn over a 12-month period. This definition differs from loan impairment allowances, which only address losses incurred within lending portfolios at the balance sheet date and are not permitted to recognise the additional level of conservatism that the regulatory measure requires through reflecting a downturn scenario. For rapidly revolving consumer credit portfolios such as credit cards, therefore, impairment allowances only capture some of the expected losses predicted over the next 12 months. These portfolios turn over three to four times per year, and therefore a large proportion of expected losses relate to credit advances not made at the measurement date.

The effect of the deduction of the difference between expected losses and total impairment allowances is to set the total effect on capital to be equal to the regulatory definition of expected losses. Because expected losses are based on long-term estimates and incorporate through-the-cycle considerations, it is not anticipated that they will be very volatile. The impact of this deduction, however,

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may vary from time to time as the accounting measure of impairment moves closer to or further away from the regulatory measure of expected losses.

The second pillar of Basel II (Supervisory Review and Evaluation Process) involves both firms and regulators taking a view on whether a firm should hold additional capital against risks not covered in pillar 1. Part of the pillar 2 process is the Internal Capital Adequacy Assessment Process which is the firm's self assessment of risks not captured by pillar 1. The pillar 2 process culminates with the FSA providing firms with Individual Capital Guidance. The ICG replaces the current trigger ratio and is set as a capital resources requirement higher than that required under pillar 1, generally by a specified percentage.

Pillar 3 of Basel II is related to market discipline and aims to make firms more transparent by requiring them to publish specific, prescribed details of their risks, capital and risk management under the

Basel II framework. HSBC will provide qualitative pillar 3 disclosures during 2008, with the first full set of pillar 3 disclosures including quantitative tables, being made during the first half of 2009 as of 31 December 2008.

For individual banking subsidiaries, the timing and manner of implementing Basel II varies by jurisdiction according to requirements set by local banking supervisors. Applying Basel II across HSBC's geographically diverse businesses, which operate in a large number of different regulatory environments, presents a significant logistical and technological challenge, involving an extensive programme of implementation.

Basel II allows local regulators to exercise discretion in a number of areas. The extent to which their requirements diverge, coupled with how the FSA and the local regulators in the other countries in which HSBC operates interact, are key factors in completing implementation of Basel II locally.

### Source and application of tier 1 capital – Basel I

(Audited)

	2007 US\$m	2006 US\$m
<b>Movement in tier 1 capital</b>		
At 1 January	<b>87,842</b>	74,403
Consolidated profits attributable to shareholders of the parent company	<b>19,133</b>	15,789
Dividends	<b>(10,241)</b>	(8,769)
Add back: shares issued in lieu of dividends	<b>4,351</b>	2,525
Increase in goodwill and intangible assets deducted	<b>(2,366)</b>	(3,668)
Ordinary shares issued	<b>477</b>	1,015
Other (including exchange differences)	<b>5,771</b>	6,547
	<hr/>	<hr/>
At 31 December	<b>104,967</b>	87,842
	<hr/>	<hr/>
<b>Movement in risk-weighted assets</b>		
(Unaudited)		
At 1 January	<b>938,678</b>	827,164
Movements	<b>185,104</b>	111,514
	<hr/>	<hr/>
At 31 December	<b>1,123,782</b>	938,678
	<hr/>	<hr/>



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HSBC HOLDINGS PLC

**Report of the Directors: The Management of Risk** (continued)*Capital management and allocation > RWAs***Capital structure at 31 December □ Basel I**

	2007 US\$m	2006 US\$m
<b>Composition of regulatory capital</b> <i>(Audited)</i>		
Tier 1 capital		
Shareholders' equity	128,160	108,352
Minority interests and preference shares	6,240	7,413
Innovative tier 1 securities	10,512	9,932
Less :		
Goodwill capitalised and intangible assets	(38,855)	(36,489)
Other regulatory adjustments <sup>1</sup>	(1,090)	(1,366)
	<u>104,967</u>	<u>87,842</u>
Tier 2 capital		
Reserves arising from revaluation of property and unrealised gains onavailable-for-sale equities	4,393	2,982
Collective impairment allowances	14,047	11,077
Perpetual subordinated debt	3,114	3,396
Term subordinated debt	37,658	30,677
Minority and other interests in tier 2 capital	300	425
	<u>59,512</u>	<u>48,557</u>
Unconsolidated investments <sup>2</sup>	(11,092)	(7,512)
Investments in capital of other banks	□	(1,419)
Other deductions	(747)	(394)
	<u>152,640</u>	<u>127,074</u>
<b>Risk-weighted assets</b> <i>(Unaudited)</i>		
Banking book	1,020,747	857,198
Trading book	103,035	81,480
	<u>1,123,782</u>	<u>938,678</u>
Risk-weighted assets were included in the totals above in respect of:		
□ contingent liabilities	51,731	44,704
□ commitments	65,068	58,569
<b>Capital ratios</b> <i>(Unaudited)</i>		
	%	%
Total capital	13.6	13.5

Tier 1 capital

**9.3**

9.4

- 1 *Includes removal of the fair value gains and losses, net of deferred tax, arising from the credit spreads on debt issued by HSBC Holdings and its subsidiaries and designated at fair value.*
- 2 *Mainly comprises investments in insurance entities.*

HSBC complied with the FSA's capital adequacy requirements throughout 2007 and 2006. Tier 1 capital increased by US\$17.1 billion. Retained profits contributed US\$8.9 billion, shares issued, including shares issued in lieu of dividends, contributed US\$4.8 billion and exchange differences added US\$5.5 billion. These increases were partly offset by an increase in goodwill and intangible assets, which are deducted from capital, of US\$2.4 billion, and are mainly due to the weakening of the US dollar against the pound sterling and the euro.

Total risk-weighted assets increased by US\$185 billion, or 19.7 per cent. Of this increase,

US\$95 billion reflects balance sheet growth, mainly in the loan book. A further US\$39 billion arose from the proportional consolidation of banking associates, mainly Bank of Communications and Industrial Bank. The weakening US dollar gave rise to an increase of US\$32 billion while increased trading book activity contributed US\$19 billion.

Risk-weighted assets by principal subsidiary  
(Unaudited)

In order to give an indication of how HSBC's capital is deployed, the table below analyses the disposition of risk-weighted assets by principal subsidiary. The risk-weighted assets are calculated using FSA rules and exclude intra-HSBC items.

[Back to Contents](#)**Risk-weighted assets □ Basel I***(Unaudited)*

	<b>2007</b>	2006
	<b>US\$m</b>	US\$m
The Hongkong and Shanghai Banking Corporation	<b>256,761</b>	181,292
Hang Seng Bank	<b>55,043</b>	43,607
The Hongkong and Shanghai Banking Corporation and other subsidiaries	<b>201,718</b>	137,685
HSBC Bank	<b>423,941</b>	360,028
HSBC Private Banking Holdings (Suisse)	<b>32,942</b>	26,476
HSBC France	<b>76,188</b>	60,406
HSBC Bank and other subsidiaries	<b>314,811</b>	273,146
HSBC North America	<b>336,998</b>	317,325
HSBC Finance	<b>135,757</b>	141,589
HSBC Bank Canada	<b>50,659</b>	35,674
HSBC Bank USA and other subsidiaries	<b>150,582</b>	140,062
HSBC Mexico	<b>18,513</b>	15,406
HSBC Bank Middle East	<b>25,226</b>	17,977
HSBC Bank Malaysia	<b>8,601</b>	7,201
HSBC Brazil	<b>27,365</b>	17,666
HSBC Bank Panama	<b>7,824</b>	6,434
Bank of Bermuda	<b>4,133</b>	4,370
HSBC Holdings sub-group	<b>1,138</b>	876
Other	<b>13,282</b>	10,103
	<b>1,123,782</b>	938,678



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HSBC HOLDINGS PLC

**Report of the Directors: The Management of Risk** (continued)

*Capital management and allocation > Impact of Basel II /  
Biographies > Directors*

**Impact of Basel II***(Unaudited)*

As reflected in the table below, the Group's capital base under Basel II is US\$19.7 billion lower than under Basel I. This reduction in the capital base does not reflect a change in the risk profile of the underlying portfolios and the Group remains strongly capitalised.

The Group's risk-weighted assets under Basel II are broadly similar to the Basel I position. A reduction in the credit risk capital requirement has been more than offset by the new capital requirement for operational risk.

The Group's pro-forma capital position if it had been reporting on a Basel II basis at 31 December 2007 is as follows:

**Capital position under Basel II**

	<b>Basel II pro-forma US\$m (Unaudited)</b>	<b>Basel II pro-forma %<sup>1</sup> (Unaudited)</b>	Basel I Actual US\$m (Audited)
<b>Composition of regulatory capital</b>			
Tier 1 capital			
Shareholders' equity	128,160		128,160
Minority interests and preference shares	6,240		6,240
Less :			
Goodwill capitalised and intangible assets	(38,855)		(38,855)
Other regulatory adjustments <sup>2,3</sup>	136		(1,090)
50% of excess of expected losses over impairment allowances	(4,508)		□
Core tier 1 capital	<b>91,173</b>	<b>8.1</b>	94,455
Innovative tier 1 securities	10,512	0.9	10,512
Tier 1 capital ratio □ management basis		<b>9.0</b>	
Tier 2 capital			
Reserves arising from revaluation of property and unrealised gains on available-for-sale equities	4,393		4,393
Collective impairment allowances <sup>4</sup>	2,176		14,047
Perpetual subordinated debt	3,114		3,114
Term subordinated debt	37,658		37,658
Minority and other interests in tier 2 capital	300		300
Total qualifying tier 2 capital before deductions	<b>47,641</b>	<b>4.2</b>	59,512

Total qualifying tier 2 capital before deductions plus innovative tier 1 securities	<b>58,153</b>		70,024
Unconsolidated investments <sup>5</sup>	<b>(11,092)</b>		(11,092)
50% of excess of expected losses over impairment allowances	<b>(4,508)</b>		□
Other deductions	<b>(747)</b>		(747)
Total deductions other than from tier 1 capital	<b>(16,347)</b>	<b>(1.4)</b>	(11,839)
Total regulatory capital	<b>132,979</b>	<b>11.8</b>	152,640
			<i>(Unaudited)</i>
<b>Risk-weighted assets</b>			
Credit risk	<b>976,138</b>		□
Market risk	<b>45,847</b>		□
Operational risk	<b>107,466</b>		□
Banking book	□		1,020,747
Trading book	□		103,035
Total	<b>1,129,451</b>		1,123,782

- 1 *Percentage of risk-weighted assets.*
- 2 *Includes removal of the fair value gains and losses, net of deferred tax, arising from the credit spreads on debt issued by HSBC Holdings and its subsidiaries and designated at fair value.*
- 3 *Includes a tax credit adjustment in respect of the excess of expected losses over impairment allowances.*
- 4 *Under Basel II, only collective impairment allowances on loan portfolios on the standardised approach are included in tier 2 capital.*
- 5 *Mainly comprises investments in insurance entities.*

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**Report of the Directors: Governance**

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**Corporate Governance Report**

The information set out on pages 289 to 333 and information incorporated by reference constitutes the Corporate Governance Report of HSBC Holdings.

**Directors**

**S K Green** , Group Chairman

Age 59. An executive Director since 1998; Group Chief Executive from 2003 to May 2006. Joined HSBC in 1982. Chairman of HSBC Bank plc and HSBC North America Holdings Inc. and HSBC Private Banking Holdings (Suisse) SA. A Director of HSBC France and The Hongkong and Shanghai Banking Corporation Limited. Group Treasurer from 1992 to 1998. Executive Director, Global Banking and Markets from 1998 to 2003. Chairman of The British Bankers' Association.

- \* **The Baroness Dunn** , DBE, Deputy Chairman  
(Retiring 30 May 2008)

Age 68. An executive Director of John Swire & Sons Limited and a Director of Swire Pacific Limited. A non-executive Director since 1990 and a non- executive Deputy Chairman since 1992. A member of the Nomination Committee. A non-executive Director of The Hongkong and Shanghai Banking Corporation Limited from 1981 to 1996. A Patron of the UK Foundation of the University of British Columbia, a registered charity. A member of the Hong Kong Association and the Asia Task Force. A former Senior Member of the Hong Kong Executive Council and Legislative Council.

- \* **Sir Brian Moffat** , OBE, Deputy Chairman  
(Retiring 30 May 2008)

Age 69. A non-executive Director since 1998 and a non-executive Deputy Chairman since 2001. A member of the Nomination Committee. A non- executive Director of Macsteel Global BV. Former Chairman of Corus Group plc and a former member of the Court of the Bank of England.

**MF Geoghegan** , CBE, Group Chief Executive

Age 54. An executive Director since 2004. Joined HSBC in 1973. Chairman of the Group Management Board. Chairman of HSBC Bank USA, N.A., HSBC USA Inc. and HSBC Bank Canada. Deputy Chairman of HSBC Bank plc. A Director of The Hongkong and Shanghai Banking Corporation Limited, HSBC France, HSBC National Bank USA and HSBC North America Holdings Inc. President of HSBC Bank Brasil S.A.-Banco Múltiplo from 1997 to 2003 and responsible for all of HSBC's business throughout South America from 2000 to 2003. Chief Executive of HSBC Bank plc from 2004 to March 2006. A non-executive Director and Chairman of Young Enterprise.

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**Report of the Directors: Governance** (continued)*Biographies > Directors*\* **The Rt Hon the Lord Butler of Brockwell,**  
KG, GCB, CVO (*Retiring 30 May 2008*)

Age 70. Master, University College, Oxford. A non-executive Director since 1998. Chairman of the Corporate Sustainability Committee and the HSBC Global Education Trust. A member of the International Advisory Board of Marsh McLennan Inc. Chaired the UK Government Review of Intelligence on Weapons of Mass Destruction in 2004. Secretary of the Cabinet and Head of the Home Civil Service in the United Kingdom from 1988 to 1998. A non-executive Director of Imperial Chemical Industries plc from 1998 to 2 January 2008.

□ **S A Catz** (*Appointed 1 May 2008*)

Age 46. A non-executive Director with effect from 1 May 2008. President and Chief Financial Officer of Oracle Corporation. Managing Director of Donaldson, Lufkin & Jenrette from 1997 to 1999. Joined Oracle in 1999 and appointed to the Board of Directors in 2001.

**V H C Cheng**, OBE

Age 59. Chairman of The Hongkong and Shanghai Banking Corporation Limited. An executive Director since 1 February 2008. Chairman of HSBC Bank (China) Company Limited and HSBC Investments (Hong Kong) Limited and a Director of HSBC Bank Australia Limited. Joined HSBC in 1978. Appointed a Group General Manager in 1995 and a Group Managing Director in 2005. A Director of Great Eagle Holdings Limited and a Member of the Exchange Fund Advisory Committee of the Hong Kong Monetary Authority. Vice Chairman of the China Banking Association from 10 December 2007. Appointed a member of the National Committee of the 11th Chinese People's Political Consultative Conference (CPPCC), and a senior advisor to the 11th Beijing Municipal Committee of the CPPCC. Deputy Chairman and Chief Executive Officer of Hang Seng Bank Limited from 1998 to 2005. A Director of Swire Pacific Limited from 2005 to January 2008.

□ **J D Coombe**

Age 62. Chairman of Hogg Robinson plc. A non-executive Director since 2005. A member of the Group Audit Committee and of the Remuneration Committee. A non-executive Director of Home Retail Group plc. A trustee of the Royal Academy Trust. Former executive Director and Chief Financial Officer of GlaxoSmithKline plc and a former member of the Supervisory Board of Siemens AG. A former Chairman of The Hundred Group of Finance Directors and a former member of the Accounting Standards Board.

□ **J L Durán**

Age 43. Chief Executive of Carrefour SA and Chairman of its Management Board of Directors. A non-executive Director since 1 January 2008. Joined Carrefour SA in 1991. Chief Financial Officer and Managing Director, Organisation and Systems of Carrefour SA from 2001 to 2005.

□ **R A Fairhead**

Age 46. Chief Executive Officer and Director of the Financial Times Group Limited and a Director of Pearson plc. Chairman of Interactive Data Corporation. A non-executive Director since 2004. Chairman of the Group Audit Committee. A non-executive Director of The Economist Newspaper Limited. Finance Director of Pearson plc from 2002 to June 2006. Former Executive Vice President, Strategy and Group Control of Imperial Chemical Industries plc.

**D J Flint** , CBE, Group Finance Director

Age 52. Joined HSBC as an executive Director in 1995. Non-executive Chairman of HSBC Finance Corporation. A non-executive Director of BP p.l.c. and a member of the Consultative Committee of the Large Business Advisory Board of HM Revenue & Customs. Chaired the Financial Reporting Council's review of the Turnbull Guidance on Internal Control. Served on the Accounting Standards Board and the Standards Advisory Council of the International Accounting Standards Board from 2001 to 2004. A former partner in KPMG.

**A A Flockhart** , CBE (*Appointed 1 May 2008*)

Age 56. Chief Executive Officer of The Hongkong and Shanghai Banking Corporation Limited and Global Head of Commercial Banking. An executive Director with effect from 1 May 2008. Joined HSBC in 1974. A Director of Hang Seng Bank Limited, HSBC Bank Australia Limited, HSBC Bank (China) Company Limited, and Chairman of HSBC Bank Malaysia Berhad. Managing Director of The Saudi British Bank from 1997 to 1999 and Senior Executive Vice-President, Commercial Banking, HSBC Bank USA, N.A. from 1999 to 2002. Chief Executive Officer, Mexico from 2002 to October 2006. President and Group Managing Director Latin America and the Caribbean from October 2006 to 20 July 2007. Appointed a Group General Manager in 2002 and a Group Managing Director in 2006.

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\* **W K L Fung**, OBE

Age 59. Group Managing Director of Li & Fung Limited. A non-executive Director since 1998. A member of the Corporate Sustainability Committee. Deputy Chairman of The Hongkong and Shanghai Banking Corporation Limited. A Director of King Lun Management Limited. A non-executive Director of CLP Holdings Limited, Integrated Distribution Services Group Limited, Convenience Retail Asia Limited, Shui On Land Limited and VTech Holdings Limited. A member of the Hong Kong Trade Development Council. A former non-executive Director of Bank of Communications Co. Ltd. Former Chairman of the Hong Kong General Chamber of Commerce, the Hong Kong Exporters' Association and the Hong Kong Committee for the Pacific Economic Cooperation Council.

**S T Gulliver** (*Appointed 1 May 2008*)

Age 48. Head of Global Banking and Markets and HSBC Global Asset Management. An executive Director with effect from 1 May 2008. Joined HSBC in 1980. A Director of HSBC Bank plc, HSBC Private Banking Holdings (Suisse) SA, HSBC USA Inc. and The Hongkong and Shanghai Banking Corporation Limited. A member of the Supervisory Board of HSBC Trinkaus & Burkhardt AG. Head of Treasury and Capital Markets in Asia-Pacific from 1996 to 2002. Head of Global Markets from 2002 to 2003 and Co-Head of Global Banking and Markets from 2003 to May 2006. Appointed a Group General Manager in 2000 and a Group Managing Director in 2004.

□ **J W J Hughes-Hallett**

Age 58. Chairman of John Swire & Sons Limited. A non-executive Director since 2005. A member of the Group Audit Committee and of the Nomination Committee. A non-executive Director of The Hongkong and Shanghai Banking Corporation Limited from 1999 to 2004. A non-executive Director and formerly Chairman of Cathay Pacific Airways Limited and Swire Pacific Limited. A director of China Festival 2008. A trustee of the Dulwich Picture Gallery and the Esmée Fairbairn Foundation. A member of the Hong Kong Association and of the Governing Body of the School of Oriental and African Studies, University of London.

□ **W S H Laidlaw**

Age 51. Chief Executive Officer of Centrica plc. A non-executive Director since 1 January 2008. A Trustee of RAFT, a medical charity for burns and reconstructive surgery. A member of the Business Council for International Understanding. President and Chief Operating Officer of Amerada Hess Corporation from 1995 to 2001. Chief Executive Officer of Enterprise Oil plc from 2001 to 2002. Executive Vice President of Chevron Corporation from 2003 to 2006, and a non-executive Director of Hanson PLC from 2003 to 24 August 2007.

□ **Sir Mark Moody-Stuart**, KCMG

Age 67. Chairman of Anglo American plc. A non-executive Director since 2001. Chairman of the Remuneration Committee and a member of the Corporate Sustainability Committee. A non-executive Director of Accenture Limited, Saudi Aramco, a Governor of Nuffield Hospitals and President of the Liverpool School of Tropical Medicine. Chairman of the Global Business Coalition on HIV/AIDS and the Global Compact Foundation. A former Director and Chairman of The [Shell] Transport and Trading Company, plc and former Chairman of the Committee of Managing Directors of the Royal Dutch/Shell Group of Companies.

□ **G Morgan**

Age 62. A non-executive Director since October 2006. A member of the Remuneration Committee. Non-executive chairman of SNC-Lavalin Group Inc. A member of the Board of Trustees of The Fraser Institute and the Energy Advisory Board of Accenture Limited. A non-executive Director of HSBC Bank Canada from 1996 until April 2006. Former Founding President, Chief Executive Officer and Vice Chairman of EnCana Corporation. A former Director of Alcan Inc.

□ **N R N Murthy**, CBE (*Appointed 1 May 2008*)

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Age 61. A non-executive Director with effect from 1 May 2008. Chairman and Chief Mentor and former Chief Executive Officer of Infosys Technologies Limited. An independent non-executive Director of Unilever plc and New Delhi Television Limited and a Director of the United Nations Foundation. An independent non-executive Director of DBS Bank Limited until 2 April 2008.

□ **S W Newton**

Age 66. Chairman of The Real Return Group Limited. A non-executive Director since 2002. A member of the Group Audit Committee. A member of the Investment Committee of The Wellcome Trust, and the Investment Board of Cambridge University. A Council Member of Imperial College,



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HSBC HOLDINGS PLC

**Report of the Directors: Governance** (continued)*Biographies > Senior Management*

London, and Chairman of the committee advising the Council on the College Fund. An advisor to the Investment Committee of the Royal Marsden NHS Foundation Trust.

□ **S M Robertson**, senior independent non-executive Director

Age 66. Non-executive Chairman of Rolls-Royce Group plc and the founder member of Simon Robertson Associates LLP. A non-executive Director since January 2006 and senior independent non-executive Director since 25 May 2007. A member of the Nomination Committee. A non-executive Director of Berry Bros. & Rudd Limited, The Economist Newspaper Limited and The Royal Opera House Covent Garden Limited. Chairman of Trustees of Ernest Kleinwort Charitable Trust. A trustee of the Eden Project and of the Royal Opera House Endowment Fund. A former Managing Director of Goldman Sachs International. Former Chairman of Dresdner Kleinwort Benson and a former non-executive Director of Inchcape plc, Invensys plc and the London Stock Exchange.

□ **Sir Brian Williamson**, CBE

Age 63. Chairman of Electra Private Equity plc. A non-executive Director since 2002. Chairman of the Nomination Committee. A non-executive Director of Resolution plc. A member of the Supervisory Board of Euronext NV. A Director of Climate Exchange plc. A senior adviser to Fleming Family and Partners. Former Chairman of London International Financial Futures and Options Exchange, Gerrard Group plc and Resolution Life Group Limited. A former non-executive Director of the Financial Services Authority and of the Court of The Bank of Ireland.

\* *Non-executive Director*

□ *Independent non-executive Director*

**Secretary****R G Barber**

Age 57. Group Company Secretary. Appointed a Group General Manager in October 2006. Joined HSBC in 1980. Company Secretary of HSBC Holdings plc since 1990. Chairman of the Disclosure Committee. A member of the Listing Authority Advisory Committee of the Financial Services Authority and of the Primary Markets Group of the London Stock Exchange. Corporation Secretary of The Hongkong and Shanghai Banking Corporation Limited from 1986 to 1992 and Company Secretary of HSBC Bank plc from 1994 to 1996.

**Adviser to the Board****D J Shaw**

Age 61. An Adviser to the Board since 1998. Solicitor. A partner in Norton Rose from 1973 to 1998. A Director of The Bank of Bermuda Limited, HSBC Private Banking Holdings (Suisse) SA. A non-executive Director of Kowloon Development Company Limited and Shui On Land Limited.

**Group Managing Directors****A Almeida**

Age 51. Group Head of Human Resources. A Group Managing Director since 25 February 2008. Joined HSBC in 1992. Appointed a Group General Manager on 18 June 2007. Global Head of Human Resources for Global Banking and Markets, Group Private Banking, Global Transaction Banking and HSBC Amanah, from 1996 to June 2007.

**C C R Bannister**

Age 49. Group Managing Director, Insurance. A Group Managing Director since August 2006. Joined HSBC in 1994. Appointed a Group General Manager in 2001. Chairman of HSBC Insurance Holdings Limited since November 2006. Deputy Chief Executive Officer, HSBC Securities (USA) Inc. from 1996 to 1997 and Chief Executive Officer, Group Private Banking from 1998 to November 2006.

**A A Flockhart , CBE**

Appointed an executive Director with effect from 1 May 2008. See page 290.

**S T Gulliver**

Appointed an executive Director with effect from 1 May 2008. See page 291.

**D H Hodgkinson**

Age 57. Group Chief Operating Officer. A Group Managing Director since May 2006 and Director of The Bank of Bermuda Limited since May 2006. Chairman of HSBC Bank Middle East Limited since July 2006. Joined HSBC in 1969. Appointed a Group General Manager in 2003. Managing Director of The Saudi British Bank from 1999 to 2003. Deputy Chairman and Chief Executive Officer of HSBC Bank Middle East Limited from 2003 to May 2006.

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### **A Hungate**

Age 41. Global Head of Personal Financial Services and Marketing. Joined HSBC as a Group Managing Director on 3 September 2007. Formerly Managing Director, Asia Pacific at Reuters. Worldwide Chief Marketing Officer of Reuters between 2002 and 2005.

### **D D J John**

Age 57. Chief Executive, HSBC Bank plc. A Group Managing Director since March 2006. Joined HSBC Bank plc in 1971. Appointed a Group General Manager in 2000. Deputy Chairman and Chief Executive Officer, HSBC Bank Malaysia Berhad from 1999 to 2002. Chief Operating Officer of HSBC Bank plc from 2003 to 2005 and Deputy Chief Executive from 2005 to March 2006.

### **B P McDonagh**

Age 49. Chief Executive Officer, HSBC North America Holdings Inc. A Group Managing Director since 21 February 2008. Joined HSBC in 1979. Appointed a Group General Manager in 2005. Chief Executive Officer, HSBC Finance Corporation and Chief Operating Officer, HSBC North America Holdings Inc. from 2007 to 21 February 2008. Chief Operating Officer, HSBC Bank USA from 2004 to 2006.

### **Y A Nasr**

Age 53. Deputy Chairman and Chief Executive of HSBC Bank Middle East Limited since 22 May 2007. A Group Managing Director since 2004. Joined HSBC in 1976. Deputy Chairman of HSBC Bank Egypt S.A.E. since 31 May 2007. A Director of HSBC Private Banking Holdings (Suisse) SA since September 2006. Appointed a Group General Manager in 1998. President and Chief Executive Officer of HSBC Bank Canada from 1997 to 1999. President and Chief Executive Officer of HSBC USA Inc. and HSBC Bank USA from 1999 to 2003. President, HSBC Bank Brasil S.A.-Banco Múltiplo from 2003 to October 2006.

### **B Robertson**

Age 53. Group Chief Risk Officer. A Group Managing Director since 25 February 2008. Joined HSBC in 1975. A Group General Manager since 2003. Head of Global Banking and Markets for North America from 2003 to 2005. Group General Manager, Group Credit and Risk from 2005 to September 2007.

## **Group General Managers**

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### **E Alonso**

Age 52. Co-Head of Latin America and President and Chief Executive Officer, HSBC Bank Brasil S.A.-Banco Múltiplo and South America. Joined HSBC in 1997. Appointed a Group General Manager in October 2006.

### **P Y Antika**

Age 47. Chief Executive Officer, HSBC Turkey. Joined HSBC in 1990. Appointed a Group General Manager in 2005.

### **R E T Bennett**

Age 56. Group General Manager, Legal and Compliance. Joined HSBC in 1979. Appointed a Group General Manager in 1998.

### **N S K Booker**

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Age 49. Chief Operating Officer, HSBC Finance Corporation and Chief Operating Officer, HSBC North America. Joined HSBC in 1981. Appointed a Group General Manager in 2004.

### **P W Boyles**

Age 52. Chief Executive Officer, HSBC France. Joined HSBC in 1975. Appointed a Group General Manager in January 2006.

### **D C Budd**

Age 54. Director, International, HSBC Bank plc. Joined HSBC in 1972. Appointed a Group General Manager in 2005.

### **Z J Cama**

Age 60. Group General Manager, International HSBC Holdings plc. Joined HSBC in 1968. Appointed a Group General Manager in 2001.

### **T M Detelich**

Age 51. President, Consumer and Mortgage Lending, HSBC Finance Corporation. Joined HSBC Finance Corporation in 1976. Appointed a Group General Manager in October 2006.

### **I M Dorner**

Age 53. Deputy Chairman and Chief Executive Officer, HSBC Bank Malaysia Berhad. Joined HSBC in 1986. Appointed a Group General Manager in June 2007.

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HSBC HOLDINGS PLC

## **Report of the Directors: Governance** (continued)

*Biographies > Senior Management / Board of Directors*

### **J D Garner**

Age 38. Group General Manager, Personal Financial Services and Direct Businesses, HSBC Bank plc. Joined HSBC in 2004. Appointed a Group General Manager in October 2006.

### **J L Gordon**

Age 55. President and Chief Executive Officer, HSBC Bank Canada. Joined HSBC in 1987. Appointed a Group General Manager in 2005.

### **K M Harvey**

Age 47. Group General Manager and Group Chief Information Officer. Joined HSBC Finance Corporation in 1989. Appointed a Group General Manager in 2004.

### **A M Keir**

Age 49. Global Co-Head Commercial Banking. Joined HSBC in 1981. Appointed a Group General Manager in October 2006.

### **N L Kidwai**

Age 50. Chief Executive Officer, HSBC India. Joined HSBC in 2002. Appointed a Group General Manager in October 2006.

### **M J W King**

Age 51. Group General Manager, Internal Audit. Joined HSBC in 1986. Appointed a Group General Manager in 2002.

### **P J Lawrence**

Age 46. Head of Global Banking and Markets, USA. President and Chief Executive Officer, HSBC Bank USA, N.A. and HSBC USA Inc. Joined HSBC in 1982. Appointed a Group General Manager in 2005.

### **M Leung**

Age 55. Global Co-Head Commercial Banking. Joined HSBC in 1978. Appointed a Group General Manager in 2005.

### **A M Mahoney**

Age 45. Group General Manager and Head of PFS Distribution. Joined HSBC in 1983. Appointed a Group General Manager in November 2006.

### **C M Meares**

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Age 50. Chief Executive Officer, Group Private Banking. Joined HSBC in 1980. Appointed a Group General Manager in November 2006.

### **W G Menezes**

Age 62. Group Executive, Card Services, HSBC Finance Corporation. Joined HSBC in 1996. Appointed a Group General Manager in October 2006.

### **K Newman**

Age 50. Senior Executive Vice President, Personal Financial Services, HSBC Bank USA, N.A. Joined HSBC in 1989. Appointed a Group General Manager in October 2006.

### **R C F Or**

Age 58. Vice-Chairman and Chief Executive, Hang Seng Bank Limited and Director, The Hongkong and Shanghai Banking Corporation Limited. Joined HSBC in 1972. Appointed a Group General Manager in 2000.

### **K Patel**

Age 59. Group General Manager, Chief Executive Officer, Africa. Joined HSBC in 1984. Appointed a Group General Manager in 2000.

### **R C Picot**

Age 50. Group Chief Accounting Officer. Joined HSBC in 1993. Appointed a Group General Manager in 2003.

### **C D Spooner**

Age 57. Head of Group Financial Planning & Tax. Joined HSBC in 1994. Appointed a Group General Manager in June 2007.

### **P A Thurston**

Age 54. Co-Head of Latin America and President of HSBC Mexico and Central America. Joined HSBC in 1975. Appointed a Group General Manager in 2003.

### **P T S Wong**

Age 56. Executive Director, Hong Kong and Mainland China, The Hongkong and Shanghai Banking Corporation Limited. Joined HSBC in 2005. Appointed a Group General Manager in 2005.

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## Board of Directors

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### The Board

The objective of the management structures within HSBC, headed by the Board of Directors of HSBC Holdings and led by the Group Chairman, is to deliver sustainable value to shareholders. Implementation of the strategy set by the Board is delegated to the Group Management Board under the leadership of the Group Chief Executive.

HSBC Holdings has a unitary Board of Directors. The authority of each Director is exercised in Board Meetings where the Board acts collectively as a unit. At 3 March 2008, the Board comprises the Group Chairman, Group Chief Executive, two other executive Directors and 14 non-executive Directors. The names and brief biographical particulars of the Directors are listed on pages 289 to 292. The Group Chairman, Group Chief Executive and two other executive Directors are employees who carry out executive functions in HSBC in addition to their duties as Directors. Non-executive Directors are not HSBC employees and do not participate in the daily business management of HSBC. Non-executive Directors bring an external perspective, constructively challenge and help develop proposals on strategy, scrutinise the performance of management in meeting agreed goals and objectives and monitor the reporting of performance. The non-executive Directors have a wealth of experience across a number of industries and business sectors, including the leadership of large, complex multinational enterprises. The roles of non-executive Directors as members of Board committees are set out on pages 300 to 304. It is estimated that non-executive Directors spend 24 days per annum on HSBC business after an induction phase, with Committee members devoting significant additional time.

The Board is responsible for managing the business of HSBC Holdings and, in doing so, may exercise all of the powers of HSBC Holdings, subject to any relevant laws and regulations and to the Memorandum and Articles of Association. In particular, the Board may exercise all the powers of the Company to borrow money and to mortgage or charge all or any part of the undertaking, property or assets (present and future) of HSBC Holdings and may also exercise any of the powers conferred on it by the Companies Act 1985 and Companies Act 2006 (as appropriate) and/or by shareholders. The Board is able to delegate and confer on certain Directors holding executive office any of its powers, authorities and discretions (including the power to sub-delegate) for such time and on such terms as it

thinks fit. In addition, the Board may establish any local or divisional boards or agencies for managing the business of HSBC Holdings in any specified locality and delegate and confer on any local or divisional board, manager or agent so appointed any of its powers, authorities and discretions (including the power to sub-delegate) for such time and on such terms as it thinks fit. The Board may also, by power of attorney or otherwise, appoint any person or persons to be the agent of HSBC Holdings and may delegate to any such person or persons any of its powers, authorities and discretions (including the power to sub-delegate) for such time and on such terms as it thinks fit.

The Board sets the strategy for HSBC through the five-year strategic plan and approves the operating plans presented by management for the achievement of the strategic objectives. The operating plans ensure the efficient disposition of HSBC's resources for the achievement of these objectives. The Board delegates the management and day-to-day running of HSBC to the Group Management Board but retains to itself approval of certain matters including operating plans and performance targets, procedures for monitoring and control of operations, the authority or the delegation of authority to approve credit, market risk limits, acquisitions, disposals, investments, capital expenditure or realisation or creation of a new venture, specified senior appointments, and any substantial change in balance sheet management policy.

The Directors who served during the year were, Lord Butler, R K F Chien, J D Coombe, Baroness Dunn, R A Fairhead, D J Flint, W K L Fung, M F Geoghegan, S K Green, S Hintze, J W J Hughes-Hallett, Sir Brian Moffat, Sir Mark Moody-Stuart, G Morgan, S W Newton, S M Robertson, H Sohmen and Sir Brian Williamson. J F Gil Díaz was appointed a Director on 2 January 2007 and resigned on 5 March 2007.

The Board of Directors meets regularly and Directors receive information between meetings about the activities of committees and developments in HSBC's business.

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Eight Board meetings were held during 2007. The table that follows gives details of Directors' attendance at meetings of the Board, Group Audit Committee, Nomination Committee and Remuneration Committee during 2007.

During 2007, the non-executive Directors and the Group Chairman met twice without the presence of the Group Chief Executive and Group Finance Director. In addition, the non-executive Directors



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**Report of the Directors: Governance** (continued)**Board of Directors / The Board**

met four times without the Group Chairman including a meeting to appraise the Group Chairman's performance.

In addition to the meetings of the principal Committees referred to in the following pages,

sixteen other meetings of Committees of the Board were held during the year to discharge business delegated by the Board.

All Directors attended the 2007 Annual General Meeting.

	Board Meetings		Group Audit Committee Meetings		Nomination Committee Meetings		Remuneration Committee Meetings	
	Attended	Possible <sup>1</sup>	Attended	Possible	Attended	Possible	Attended	Possible
Lord Butler	7	8	0	0	0	0	0	0
Baroness Dunn	8	8	0	0	2	2	0	0
R K F Chien	5	5 <sup>2</sup>	2	3 <sup>2</sup>	0	0	0	0
J D Coombe	8	8	7	7	0	0	8	8
R A Fairhead	6	8	7	7	0	0	0	0
D J Flint	8	8	0	0	0	0	0	0
W K L Fung	6	8	0	0	0	0	4	4 <sup>3</sup>
M F Geoghegan	8	8	0	0	0	0	0	0
J F Gil Díaz <sup>4</sup>	0	3	0	0	0	0	0	0
S K Green	8	8	0	0	0	0	0	0
S Hintze	5	5 <sup>2</sup>	0	0	0	0	3	4 <sup>2</sup>
J W J Hughes-Hallett	7	8	6	7	2	2	0	0
Sir Brian Moffat	7	8	3	3 <sup>3</sup>	2	2	0	0
Sir Mark Moody-Stuart	8	8	0	0	0	0	8	8
G Morgan	6	8	0	0	0	0	4	4 <sup>5</sup>
S W Newton	8	8	4	4 <sup>5</sup>	0	0	0	0
S M Robertson	7	8	0	0	1	2	0	0
H Sohmen	4	5 <sup>2</sup>	0	0	0	0	0	0
Sir Brian Williamson	8	8	0	0	2	2	0	0

1 Includes a meeting called at short notice in February 2007 to discuss a trading update about the mortgage services operation in HSBC Finance Corporation.

2 Retired as a Director on 25 May 2007.

3 Ceased to be a member on 25 May 2007.

4 Retired as a Director on 5 March 2007.

5 Appointed a member on 25 May 2007.

#### Group Chairman and Group Chief Executive

The roles of Group Chairman and Group Chief Executive are separated and held by experienced full-time Directors.

There is a clear division of responsibilities at the head of the Company between the running of the Board and the executive responsibility for running HSBC's business. The Group Chairman's responsibilities include the long-term strategic development of HSBC, the development of relationships with governments and other significant external parties and performance appraisal of the Group Chief Executive. The Group Chairman also monitors the performance of the Group Finance Director and, subject to the Group Chief Executive's recommendation, approves risk, capital allocation and capital investment decisions within authorities delegated by the Board. The Group Chief Executive has responsibility for developing business plans and delivering performance against these.

S K Green became Group Chairman at the conclusion of the Annual General Meeting on 26 May 2006 and M F Geoghegan succeeded

S K Green as Group Chief Executive. The appointments were made after consulting with representatives of major institutional investors and explaining the succession planning and independent external search process undertaken. S K Green and M F Geoghegan stood for re-election at the 2006 Annual General Meeting and were both re-elected ahead of taking up their new roles from the conclusion of that Meeting.

#### Board balance and independence of Directors

The balance of the Board includes a strong presence of both executive and non-executive Directors such that no individual or small group can dominate the Board's decision making. Following the 2008 Annual General Meeting, the Board will comprise 19 Directors, 12 of whom are independent non-executive Directors. The size of the Board is appropriate given the complexity and geographical spread of HSBC's business and the significant time demands placed on the non-executive Directors, particularly those who serve as members of Board committees.

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The Board has appointed S M Robertson as the senior independent non-executive Director. The principal role of the senior independent non-executive Director is to support the Group Chairman in his role, to lead the non-executive Directors in the oversight of the Group Chairman and to ensure there is a clear division of responsibility between the Group Chairman and Group Chief Executive. The senior independent non-executive Director is also available to shareholders for concerns which the normal channels have failed to resolve or are inappropriate.

The Board considers all of the non-executive Directors to be independent in character and judgement. Baroness Dunn, Sir Brian Moffat, Lord Butler and W K L Fung have served on the Board for more than nine years, however, and in that respect only, do not meet the usual criteria for independence set out in the UK Combined Code on corporate governance. The Board has therefore determined S A Catz, J D Coombe, J L Durán, R A Fairhead, J W J Hughes-Hallett, W S H Laidlaw, Sir Mark Moody-Stuart, G Morgan, N R N Murthy, S W Newton, S M Robertson, and Sir Brian Williamson to be independent. In reaching its determination of each non-executive Director's independence the Board has concluded that there are no relationships or circumstances which are likely to affect a Director's judgement and any relationships or circumstances which could appear to do so were considered not to be material.

When determining independence the Board considers that calculation of the length of service of a non-executive Director begins on the date of his or her first election by shareholders as a Director of HSBC Holdings. Given the complexity and geographical spread of HSBC's business, the experience of previous service on a subsidiary company Board can be a considerable benefit to HSBC and does not detract from a Director's independence.

In accordance with the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited, each non-executive Director determined by the Board to be independent has provided an annual confirmation of his or her independence to HSBC Holdings.

#### Information, induction and ongoing development

The Board regularly reviews reports on progress against financial objectives, on business developments and on investor and external relations and receives reports from the Chairmen of Board Committees and from the Group Chief Executive.

The Board receives regular reports and presentations on strategy and developments in the customer groups and principal geographical areas. Regular reports are also provided to the Board, the Group Audit Committee and the Group Management Board on credit exposures and the loan portfolio, asset and liability management, liquidity, litigation and compliance and reputational issues. The agenda and supporting papers are distributed in advance of all Board and Committee meetings to allow time for appropriate review and to facilitate full discussion at the meetings. All Directors have full and timely access to all relevant information and may take independent professional advice if necessary.

The Directors have free and open contact with management at all levels. Group Managing Directors and Group General Managers meet informally with Directors after Board meetings. Board offsite visits are made each year to enable Directors to see at first hand the operations of subsidiary companies in local environments and to meet management, employees and customers. In 2007 the Board visited New York and Curitiba.

Full, formal and tailored induction programmes, with particular emphasis on internal controls, are arranged for newly appointed Directors. The programmes consist of a series of meetings with other Directors and senior executives to enable new Directors to receive information and familiarise themselves with HSBC's strategy, operations and internal controls. Prior to their appointment, each Director receives comprehensive guidance on the duties and liabilities of a Director of HSBC Holdings. Opportunities to update and develop skills and knowledge, through externally run seminars and through briefings by senior executives, are provided to all Directors.

#### Performance evaluation

In November 2007, ICSA Corporate Services Limited was commissioned to undertake an evaluation of the effectiveness of the Board. This was to investigate the performance of the Board as a whole and, in that context, the main Board committees and individual Directors. The evaluation examined whether eight key areas met the Board's needs and expectations: Board responsibilities; oversight; Board meetings; information received; support for the Board; Board composition; working together; and outcome and achievements. The report on the evaluation has been reviewed by the Board and has been used by the non-executive Directors, led by the senior independent non-executive Director, in their evaluation of the performance of

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HSBC HOLDINGS PLC

## Report of the Directors: Governance (continued)

*Board of Directors > The Board / Corporate governance codes*

the Group Chairman. The review concluded that the Board and its committees were functioning effectively. It is the intention of the Board of HSBC Holdings to continue to review its performance and that of its Directors annually.

### Appointment, retirement and re-election of Directors

The Board may at any time appoint any person who is willing to act as a Director, either to fill a vacancy or as an addition to the existing Board, but the total number of Directors shall not exceed twenty-five. Any Director so appointed by the Board shall retire at the Annual General Meeting following their appointment and shall be eligible for re-election but is not taken into account in determining the number of Directors who are to retire by rotation at such meeting. The Board may appoint any Director to hold any employment or executive office and may revoke or terminate any such appointment. Shareholders may, by ordinary resolution, appoint a person as a Director or remove any Director before the expiration of his period of office. At each Annual General Meeting, one third of the Directors who are subject to retirement by rotation are required to retire and may offer themselves for re-election by shareholders. In addition to those required to retire by rotation, any Director who was not elected or reelected at either of the preceding two Annual General Meetings and any non-executive Director who has served in office for a continuous period of nine years or more at the date of the Annual General Meeting is required to retire and may offer him or herself for re-election by shareholders.

R K F Chien, S Hintze and H Sohmen retired as Directors at the conclusion of the Annual General Meeting held on 25 May 2007. J L Durán and W S H Laidlaw were appointed non-executive Directors on 1 January 2008. V H C Cheng was appointed an executive Director on 1 February 2008. A A Flockhart and S T Gulliver have been appointed executive Directors, and S A Catz and N R N Murthy have been appointed non-executive Directors with effect from 1 May 2008.

S A Catz, V H C Cheng, J L Durán, A A Flockhart, S T Gulliver, W S H Laidlaw and N R N Murthy, having been appointed since the Annual General Meeting in 2007, will retire at the forthcoming Annual General Meeting and offer themselves for re-election.

Lord Butler, J D Coombe, Baroness Dunn, D J Flint, W K L Fung, J W J Hughes-Hallett, Sir Brian Moffat and S W Newton will retire by rotation at the forthcoming Annual General Meeting. With

the exception of Lord Butler, Baroness Dunn and Sir Brian Moffat, who are to retire, they offer themselves for re-election.

None of the non-executive Directors seeking re-election at the forthcoming Annual General Meeting has a service contract. Of the executive Directors who are seeking re-election, D J Flint is employed on a rolling contract dated 29 September 1995 which requires 12 months' notice to be given by the Company and nine months' notice to be given by Mr Flint. V H C Cheng and A A Flockhart are employed on rolling contracts dated 1 October 1978 and 6 July 1974 respectively, which require three months' notice to be given by either party. S T Gulliver is employed on a rolling contract dated 8 December 2005 which requires twelve months' notice to be given by either party.

Following the performance evaluation of the Board, the Group Chairman has confirmed that the non-executive Directors standing for re-election at the Annual General Meeting continue to perform effectively and to demonstrate commitment to their roles.

Brief biographical particulars of all Directors including those seeking re-election at the Annual General Meeting, are given on pages 289 to 292.

#### Relations with shareholders

The Board ensures all Directors, including non-executive Directors, develop an understanding of the views of major shareholders through attendance at analyst presentations and other meetings with institutional investors and their representative bodies. The Board also met with representatives of institutional shareholders in 2007 to discuss corporate governance matters.

The Group Chairman, Group Chief Executive, Group Finance Director and other senior executives hold regular meetings with institutional investors and report to the Board on those meetings.

As described in the Directors' Remuneration Report, a consultation with institutional shareholders on the framework of Directors' remuneration and proposed changes to The HSBC Share Plan began in January 2008.

S M Robertson, senior independent non-executive Director since the conclusion of the 2007 Annual General Meeting, and other non-executive Directors met and corresponded with institutional investors and their representatives to discuss strategy, remuneration policy and governance. The senior independent non-executive Director is also available to shareholders should they have concerns

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which contact through the normal channels of Group Chairman, Group Chief Executive, Group Finance Director or other executives has failed to resolve or for which such contact would be inappropriate. Invitations to meet S M Robertson prior to his appointment as senior independent non-executive Director were extended to the Group's largest shareholders. The senior independent non-executive Director may be contacted through the Group Company Secretary at 8 Canada Square, London E14 5HQ.

Indemnification of Directors, relevant audit information and contracts of significance

The Articles of Association of HSBC Holdings provide that Directors are entitled to be indemnified out of the assets of the Company against claims from third parties in respect of certain liabilities arising in connection with the performance of their functions, in accordance with the provisions of the UK Companies Act 1985. Such indemnity provisions have been in place during the financial year but have not been utilised by the Directors.

Each person who is a Director at the date of approval of this report confirms that so far as the Director is aware, there is no relevant audit information of which the Company's auditor is unaware; and the Director has taken all the steps that he or she ought to have taken as a Director in order to make himself or herself aware of any relevant audit information and to establish that the Company's auditor is aware of that information. This confirmation is given pursuant to section 234ZA of the UK Companies Act 1985 and should be interpreted in accordance therewith and subject to the provisions thereof.

None of the Directors had, during the year or at the end of the year, a material interest, directly or indirectly, in any contract of significance with HSBC Holdings or any of its subsidiary undertakings.

### **Corporate governance codes**

HSBC is committed to high standards of corporate governance. HSBC Holdings has complied throughout the year with the applicable code provisions of the Combined Code on Corporate Governance issued by the Financial Reporting Council and the Code on Corporate Governance Practices in Appendix 14 to the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited.

The Board of HSBC Holdings has adopted a code of conduct for transactions in HSBC Group securities by Directors that complies with The Model

Code in the Listing Rules of the Financial Services Authority and with The Model Code for Securities Transactions by Directors of Listed Issuers (the Hong Kong Model Code) set out in the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited, save that The Stock Exchange of Hong Kong Limited has granted certain waivers from strict compliance with the Hong Kong Model Code, primarily to take into account accepted practices in the UK, particularly in respect of employee share plans. Following a specific enquiry, each Director has confirmed he or she has complied with the code of conduct for transactions in HSBC Group securities throughout the year.

Differences in HSBC Holdings/New York Stock Exchange corporate governance practices

Under the NYSE's corporate governance rules for listed companies, as a NYSE-listed foreign private issuer, HSBC Holdings must disclose any significant ways in which its corporate governance practices differ from those followed by US companies subject to NYSE listing standards. HSBC Holdings believes the following to be the significant differences between its corporate governance practices and NYSE corporate governance rules applicable to US companies.

US companies listed on the NYSE are required to adopt and disclose corporate governance guidelines. The Listing Rules of the UK Financial Services Authority require each listed company incorporated in the UK to include in its *Annual Report and Accounts* a narrative statement of how it has applied the principles of the Combined Code and a statement as to whether or not it has complied with the code provisions of the Combined Code throughout the accounting period covered by the *Annual Report and Accounts*. A company that has not complied with the Code provisions, or complied with only some of the Code provisions or (in the case of provisions whose requirements are of a continuing nature) complied for only part of an accounting period

covered by the report, must specify the Code provisions with which it has not complied, and (where relevant) for what part of the reporting period such non-compliance continued, and give reasons for any non-compliance. As stated above, HSBC Holdings complied throughout 2007 with the applicable code provisions of the Combined Code. The Combined Code does not require HSBC Holdings to disclose the full range of corporate governance guidelines with which it complies.

Under NYSE standards, companies are required to have a nominating/corporate governance



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## Report of the Directors: Governance (continued)

*Board of Directors > Corporate governance codes / Board committees*

committee, composed entirely of independent directors. In addition to identifying individuals qualified to become Board members, this committee must develop and recommend to the Board a set of corporate governance principles. HSBC's Nomination Committee, which follows the requirements of the Combined Code, includes a majority of members who are independent. All members of the Committee are non-executive Directors and three of the five members, including the Committee chairman, are independent non-executive Directors. The Committee's terms of reference do not require the Committee to develop and recommend corporate governance principles for HSBC Holdings. As stated above, HSBC Holdings is subject to the corporate governance principles of the Combined Code.

Pursuant to NYSE listing standards, non-management directors must meet on a regular basis without management present and independent directors must meet separately at least once per year. During 2007, HSBC Holdings' non-executive Directors met twice as a group with the Group Chairman, but without the Group Chief Executive or Group Finance Director present, and met four times as a group without the Group Chairman, Group Chief Executive or Group Finance Director present. HSBC Holdings' practice, in this regard, complies with the Combined Code.

In accordance with the requirements of the Combined Code, HSBC Holdings discloses in its annual report how the Board, its committees and the Directors are evaluated (on page 297) and it provides extensive information regarding Directors' compensation in the Directors' Remuneration Report (on pages 322 to 332). The terms of reference of HSBC Holdings' Audit, Nomination and Remuneration Committees are available at [www.hsbc.com/boardcommittees](http://www.hsbc.com/boardcommittees).

NYSE listing standards require US companies to adopt a code of business conduct and ethics for directors, officers and employees, and promptly disclose any waivers of the code for directors or executive officers. In addition to the Group Business Principles and Values, which apply to the employees of all HSBC companies, pursuant to the requirements of the Sarbanes-Oxley Act the Board of HSBC Holdings has adopted a Code of Ethics applicable to the Group Chairman and the Group Chief Executive, as the principal executive officers, and to the Group Finance Director and Group Chief Accounting Officer. HSBC Holdings' Code of Ethics is available on [www.hsbc.com/codeofethics](http://www.hsbc.com/codeofethics) or from the Group Company Secretary at 8 Canada Square, London E14 5HQ. If the Board amends or waives

the provisions of the Code of Ethics, details of the amendment or waiver will appear at the same website address. During 2007, HSBC Holdings made no amendments to its Code of Ethics and granted no waivers from its provisions. The Group Business Principles and Values are available on [www.hsbc.com/businessprinciplesandvalues](http://www.hsbc.com/businessprinciplesandvalues).

Under NYSE listing rules applicable to US companies, independent directors must comprise a majority of the Board of directors. Currently, over half of HSBC Holdings' Directors are independent.

Under the Combined Code the HSBC Holdings Board determines whether a Director is independent in character and judgement and whether there are relationships or circumstances which are likely to affect, or could appear to affect, the Director's judgement. Under the NYSE rules a director cannot qualify as independent unless the Board affirmatively determines that the director has no material relationship with the listed company; in addition the NYSE rules prescribe a list of circumstances in which a director cannot be independent. The Combined Code requires a company's Board to assess director independence by affirmatively concluding that the director is independent of management and free from any business or other relationship that could materially interfere with the exercise of independent judgement.

Lastly, a chief executive officer of a US company listed on the NYSE must annually certify that he or she is not aware of any violation by the company of NYSE corporate governance standards. In accordance with NYSE listing rules applicable to foreign private issuers, HSBC Holdings Group Chief Executive is not required to provide the NYSE with this annual compliance certification. However, in accordance with rules applicable to both US companies and foreign private issuers, the Group Chief Executive is required promptly to notify the NYSE in writing after any executive officer becomes aware of any material non-compliance with the NYSE corporate governance standards applicable to HSBC Holdings.

HSBC Holdings is required to submit annual and interim written affirmations of compliance with applicable NYSE corporate governance standards, similar to the affirmations required of NYSE-listed US companies.

**Board committees**

The Board has appointed a number of committees consisting of certain Directors, Group Managing Directors and, in the case of the Corporate

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Sustainability Committee, certain co-opted non-director members. The following are the principal committees:

#### Group Management Board

The Group Management Board meets regularly and operates as a general management committee under the direct authority of the Board. The objective of the Group Management Board is to maintain a reporting and control structure whereby all of the line operations of HSBC are accountable to individual members of the Group Management Board who report to the Group Chief Executive who in turn reports to the Group Chairman. The Board has set objectives and measures for the Group Management Board. These will align senior executives' objectives and measures with the strategy and operating plans throughout HSBC. The members of the Group Management Board are M F Geoghegan (Chairman), V H C Cheng and D J Flint, who are executive Directors, and A Almeida, C C R Bannister, A A Flockhart, S T Gulliver, D H Hodgkinson, A Hungate, D D J John, B P McDonagh, Y A Nasr and B Robertson, all of whom are Group Managing Directors.

The Group Management Board exercises the powers, authorities and discretions of the Board in so far as they concern the management and day-to-day running of HSBC Holdings in accordance with such policies and directions as the Board may from time to time determine. Matters reserved for approval by the Board are described on page 295.

Following each meeting the Group Chief Executive reports to the Board on the Group Management Board's activities.

#### Group Audit Committee

The Group Audit Committee meets regularly with HSBC's senior financial, internal audit, credit, legal and compliance management and the external auditor to consider HSBC Holdings' financial reporting, the nature and scope of audit reviews and the effectiveness of the systems of internal control, compliance and risk management. The members of the Group Audit Committee throughout 2007 were, R A Fairhead (appointed Chairman on 25 May 2007), J D Coombe and J W J Hughes-Hallett. S W Newton was appointed a member of the Committee on 25 May 2007. Sir Brian Moffat ceased to be Chairman and a member of the Committee on 25 May 2007. R K F Chen retired as a Director of HSBC Holdings and ceased to be a member of the Committee on 25 May 2007. All

members of the Committee are independent non-executive Directors.

The Board has determined that R A Fairhead, J D Coombe, J W J Hughes-Hallett and S W Newton are independent according to SEC criteria, and that R A Fairhead, J D Coombe, and J W J Hughes-Hallett may be regarded as audit committee financial experts for the purposes of section 407 of the Sarbanes-Oxley Act and as having recent and relevant financial experience.

Appointments to the Committee are made for periods of up to three years, extendable by no more than two additional three-year periods, so long as members continue to be independent.

Formal and tailored induction programmes are held for newly-appointed Committee members and appropriate training is provided on an ongoing and timely basis.

There were seven meetings of the Group Audit Committee during 2007. The table on page 296 gives details of Directors' attendance at these meetings. Following each meeting the Committee reports to the Board on its activities.

At each meeting, the Committee has the opportunity to meet with the external auditor, without management present, to facilitate the discussion of any matter relating to its remit and any issue arising from the audit. Similar arrangements have been adopted for the Committee to meet with the internal auditor.

The terms of reference of the Committee, which are reviewed annually, are available at [www.hsbc.com/boardcommittees](http://www.hsbc.com/boardcommittees). To ensure consistency of scope and approach by subsidiary company audit committees, the Group Audit Committee has established core terms of reference to guide subsidiary company Boards when adopting terms of reference for their audit committees. Subsidiary company audit committees are required to provide bi-annual certificates to the Committee relating to the financial statements and internal control procedures of those subsidiaries.

The Group Audit Committee is accountable to the Board and assists it in meeting its responsibilities for maintaining an effective system of internal control and compliance and for meeting its external financial reporting obligations. The Committee undertakes an annual review of the effectiveness of HSBC's system of internal control, which is described on page 304, and reviews the Company's financial statements before they are considered by the Board.

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HSBC HOLDINGS PLC

## Report of the Directors: Governance (continued)

*Board of Directors > Board committees*

Regular reports are received on the risks involved in HSBC's business and how they are controlled and monitored by management which enable the Committee to review the effectiveness of HSBC's risk management framework. Each year the Committee agrees a schedule of presentations to be made to it by management during the ensuing year on the operation of the risk control framework within the Group. The presentations specifically address risk indicators and performance measures such as indicators of credit, liquidity and interest rate risk. During 2007 the Committee also received frequent reports on the US mortgage services business, credit performance in the US and the impact of the tightening of liquidity in the money markets. Comprehensive reports are received at each meeting from the Group Chief Risk Officer, the Head of Group Compliance, the Group General Manager, Legal and Compliance and the Group General Manager Internal Audit. Periodic presentations are made by other functional heads and line management.

The reports from the Group General Manager Internal Audit include information on frauds and special investigations and weakness in internal controls identified through internal audit reports or reviews of regulatory reports and external auditors' reports. The Committee monitors and reviews the effectiveness of the internal audit function and receives summaries of periodic peer reviews of HSBC's principal internal audit functions. HSBC has adopted the Principles of the International Institute of Internal Auditors, which include a periodic external quality assurance review of the internal audit function. The first such review was undertaken by Independent Audit Limited during 2007.

The Committee receives regular updates on changes in law, regulations and accounting standards and practices and the preparations being made to respond to those requirements. During 2007, the Committee received regular updates on the review of internal financial reporting controls required by section 404 of the Sarbanes-Oxley Act and the implementation of the Basel II capital adequacy requirements. The Committee also considered a report on HSBC's compliance with the recommendations of the Institute of International Finance's Special Committee on Liquidity Risk.

The Committee has approved procedures for the receipt, retention and handling of complaints regarding accounting, internal accounting controls and auditing matters. The Committee receives regular reports regarding the nature, investigation

and resolution of material complaints and concerns from the Head of Group Compliance.

The Committee is directly responsible on behalf of the Board for the selection, oversight and remuneration of the external auditor. The Committee reviews and monitors the external auditor's independence and objectivity and the effectiveness of the audit process, taking into consideration relevant professional and regulatory requirements.

The Committee reviews the strategy and approves the terms for the engagement of the external auditor for the audit of the Annual Report and Accounts. Regular reports on the progress of the audit facilitate the Committee's assessment of the effectiveness of the audit.

The Committee receives reports from the external auditor on its own policies and procedures regarding independence and quality control and oversees the appropriate rotation of audit partners within the external auditor. The external auditor provides the Committee with an annual confirmation of its independence in accordance with industry standards.

On the recommendation of the Committee the Board has approved a policy for the employment by HSBC of former employees of the external auditor or its affiliates. The Committee monitors this policy through the receipt of an annual report of those former employees of the external auditor employed by HSBC and the number of former employees of the external auditor currently employed in senior positions in HSBC. The reports enable the Committee to consider whether there has been any impairment, or appearance of impairment, of the auditor's judgement or independence in respect of the audit.

The Group Audit Committee has established policies for the pre-approval of specific services that may be provided by the principal auditor, KPMG Audit Plc and its affiliates (["KPMG"]). These policies are kept under review and amended as necessary to meet the dual objectives of ensuring that HSBC benefits in a cost effective manner from the cumulative knowledge and experience of its auditor, while also ensuring that the auditor maintains the necessary degree of independence and objectivity. These pre-approval policies apply to all services where HSBC Holdings or any of its subsidiaries pays for the service, or is a beneficiary or addressee of the service and has selected or influenced the choice of KPMG. All services entered into with KPMG during 2007 were pre-approved by the Committee or were entered into under pre-approval policies established by the Committee. A quarterly update on non-audit

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services provided by KPMG is presented to the Committee.

The pre-approved services relate to regulatory reviews, agreed-upon procedures reports, other types of attestation reports, the provision of advice and other non-audit services allowed under SEC independence rules. They fall into the categories of audit services, audit-related services, tax services and other services.

All services provided by KPMG relating to the implementation of section 404 of the Sarbanes-Oxley Act were specifically pre-approved by the Group Audit Committee.

An analysis of the remuneration paid in respect of audit and non-audit services provided by KPMG for each of the last three years is disclosed in Note 9 on the Financial Statements.

The Committee has recommended to the Board that KPMG Audit Plc be reappointed auditor at the forthcoming Annual General Meeting.

#### Remuneration Committee

The role of the Remuneration Committee and its membership are set out in the Directors' Remuneration Report on page 322.

#### Nomination Committee

The Nomination Committee is responsible for leading the process for Board appointments and for identifying and nominating, for approval by the Board, candidates for appointment to the Board. Before recommending an appointment to the Board, the Committee evaluates the balance of skills, knowledge and experience on the Board and, in the light of this, identifies the role and capabilities required for a particular appointment. Candidates are considered on merit against these criteria. Care is taken to ensure that appointees have enough time to devote to HSBC. Prospective Directors are asked to identify any significant other commitments and confirm they have sufficient time to discharge what is expected of them. In accordance with the Articles of Association all Directors are subject to election by shareholders at the Annual General Meeting following their appointment by the Board and to re-election at least every three years. The members of the Nomination Committee throughout 2007 were Sir Brian Williamson (appointed Chairman on 25 May 2007), Baroness Dunn and Sir Brian Moffat. J W J Hughes-Hallett and S M Robertson were appointed members of the Committee on 25 May 2007. Lord Butler ceased to be a member on 25 May 2007.

There were two Nomination Committee meetings during 2007. The table on page 296 gives details of Directors' attendance at these meetings.

Following each meeting the Committee reports to the Board on its activities.

The terms of reference of the Committee are available at [www.hsbc.com/boardcommittees](http://www.hsbc.com/boardcommittees).

The appointments of J F Gil Díaz, J L Durán and W S H Laidlaw as non-executive Directors and V H C Cheng as an executive Director were made on the advice and recommendation of the Nomination Committee. J F Gil Díaz, former Secretary of Finance and Public Credit in Mexico, was identified by the Nomination Committee and so neither an external consultancy nor open advertising was used in connection with his appointment. An external consultancy was used in connection with the appointments of J L Durán and W S H Laidlaw.

The terms and conditions of appointment of non-executive Directors are available for inspection at 8 Canada Square, London E14 5HQ and will be made available for 15 minutes before the Annual General Meeting and during the Meeting itself.

The Committee makes recommendations to the Board concerning: plans for succession for both executive and non-executive Directors; the appointment of any Director to executive or other office; suitable candidates for the role of senior independent non-executive Director; the re-election by shareholders of Directors retiring by rotation; the renewal of the terms of office of non-executive Directors; membership of Board Committees, in

consultation with the Group Chairman and the chairman of such committees as appropriate; any matters relating to the continuation in office of any Director at any time; Directors' fees and committee fees for the Company; and appointments and reappointments to the Boards of Directors of major subsidiary companies as appropriate.

The Committee regularly reviews the structure, size and composition (including the skills, knowledge and experience required) of the Board and makes recommendations to the Board as appropriate. It keeps under review the leadership needs of HSBC, with a view to ensuring the continued ability of HSBC to compete effectively in the marketplace. The Board has satisfied itself that the Nomination Committee has in place appropriate plans for orderly succession to the Board and senior management positions as well as procedures to ensure an appropriate balance of skills and experience within HSBC and on the Board.



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HSBC HOLDINGS PLC

## Report of the Directors: Governance (continued)

*Board of Directors > Board committees / Internal control*

### Corporate Sustainability Committee

The Corporate Sustainability Committee is responsible for overseeing corporate responsibility and sustainability policies, principally environmental, social and ethical matters and for advising the Board, committees of the Board and executive management on such matters. The terms of reference of the Committee are available at [www.hsbc.com/boardcommittees](http://www.hsbc.com/boardcommittees). The members of the Committee throughout 2007 were Lord Butler (Chairman), W K L Fung and Sir Mark Moody-Stuart (each of whom is a non-executive Director) and G V I Davis and Lord May, who are non-director members of the Committee. S Hintze was a member of the Committee until her retirement as a Director at the conclusion of the 2007 Annual General Meeting.

There were five meetings of the Corporate Sustainability Committee during 2007. Following each meeting the Committee reports to the Board on its activities.

Further information will be in HSBC's *Sustainability Report 2007*, available in May 2008.

### Internal control

The Directors are responsible for internal control in HSBC and for reviewing its effectiveness. Procedures have been designed for safeguarding assets against unauthorised use or disposition; for maintaining proper accounting records; and for the reliability of financial information used within the business or for publication. Such procedures are designed to manage rather than eliminate the risk of failure to achieve business objectives and can only provide reasonable and not absolute assurance against material misstatement, errors, losses or fraud. The procedures also enable HSBC Holdings to discharge its obligations under the Handbook of Rules and Guidance issued by the Financial Services Authority, HSBC's lead regulator.

The key procedures that the Directors have established are designed to provide effective internal control within HSBC and accord with the Internal Control: Revised Guidance for Directors on the Combined Code issued by the Financial Reporting Council. Such procedures for the ongoing identification, evaluation and management of the significant risks faced by HSBC have been in place throughout the year and up to 3 March 2008, the date of approval of the *Annual Report and Accounts 2007*. In the case of companies acquired during the year, the internal controls in place are being reviewed against HSBC's benchmarks and integrated into HSBC's processes.

HSBC's key internal control procedures include the following:

- Authority to operate the various subsidiaries and responsibilities for financial performance against plans and for capital expenditure is delegated to their respective chief executive officers within limits set by the Board of Directors of HSBC Holdings. Sub-delegation of authority from the Board to individuals requires these individuals, within their respective delegation, to maintain a clear and appropriate apportionment of significant responsibilities and to oversee the establishment and maintenance of systems of controls appropriate to the business. The appointment of executives to the most senior positions within HSBC requires the approval of the Board of Directors of HSBC Holdings.
- Functional, operating, financial reporting and certain management reporting standards are established by Group Head Office management committees, for application across the whole of HSBC. These are supplemented by operating standards set by functional and local management as required for the type of business and geographical location of each subsidiary.
-

Systems and procedures are in place in HSBC to identify, control and report on the major risks including credit, changes in the market prices of financial instruments, liquidity, operational error, breaches of law or regulations, unauthorised activities and fraud. Exposure to these risks is monitored by risk management committees, asset and liability committees and executive committees in subsidiaries and by the Group Management Board for HSBC as a whole. A risk management meeting of the Group Management Board, chaired by the Group Finance Director, is held monthly. These risk management meetings address asset, liability and management issues. Minutes of the risk management meetings of the Group Management Board are submitted to the Group Audit Committee and to the Board of Directors.

- A Disclosure Committee has been established to review material disclosures made by HSBC Holdings for any errors, misstatements or omissions. The membership of the Disclosure Committee, which is chaired by the Group Company Secretary, includes the heads of the Finance, Legal, Risk, Compliance, Corporate Communications, Investor Relations and Internal Audit functions and representatives

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from the principal regions, customer groups and global businesses.

- Processes are in place to identify new risks from changes in market practices or customer behaviours which could expose HSBC to heightened risk of loss or reputational damage. During 2007 attention continued to be directed towards evolving best practice in the areas of internet banking; counterparty risk management policy following the publication of the Corrigan report in July 2005; best practice guidance emerging on liquidity management from the Institute of International Finance; the implications of a slowing housing market in the US coupled with rising payment obligations under ARMs; Group exposure to monolines and money market funds; the impact on the Group of the market illiquidity situation; and the implications of changed customer behaviour in the UK regarding seeking protection from credit obligations.
- Periodic strategic plans are prepared for key customer groups, global product groups, support functions and certain geographies within the framework of the Group Strategic Roadmap. Rolling operating plans are prepared and adopted by all major HSBC operating companies, and set out the key business initiatives and the likely financial effects of those initiatives.
- Centralised functional control is exercised over all computer system developments and operations. Common systems are employed for similar business processes wherever practicable. Credit and market risks are measured and reported on in subsidiaries and aggregated for review of risk concentrations on a Group-wide basis.
- Authorities to enter into credit exposures and market risk exposures are delegated with limits to line management in the subsidiaries. In addition, functional management in Group Head Office is responsible for setting policies, procedures and standards in the following areas of risk: credit risk; market risk; liquidity risk; operational risk; IT risk; insurance risk; accounting risk; tax risk; legal and regulatory compliance risk; human resources risk; reputational risk; and purchasing risk.
- Policies to guide subsidiary companies and management at all levels in the conduct of business to safeguard the Group's reputation are established by the Board of HSBC Holdings and the Group Management Board, subsidiary

company Boards, Board committees or senior management. Reputational risks can arise from environmental, social or governance issues, or as a consequence of operational risk events. As a banking group, HSBC's good reputation depends upon the way in which it conducts its business but it can also be affected by the way in which clients, to which it provides financial services, conduct their business.

- The internal audit function, which is centrally controlled, monitors the effectiveness of internal control structures across the whole of HSBC. The work of the internal audit function is focused on areas of greatest risk to HSBC as determined by a risk-based approach. The head of this function reports to the Group Chairman and the Group Audit Committee.
- Management is responsible for ensuring that recommendations made by the internal audit function are implemented within an appropriate and agreed timetable. Confirmation to this effect must be provided to internal audit. Management must also confirm annually to internal audit that offices under their control have taken or are in the process of taking the appropriate actions to deal with all significant recommendations made by external auditors in management letters or by regulators following regulatory inspections.

The Group Audit Committee has kept under review the effectiveness of this system of internal control and has reported regularly to the Board of Directors. The key processes used by the Committee in carrying out its reviews include: regular business and operational risk assessments; regular reports from the heads of key risk functions including Internal Audit and Compliance; the production annually of reviews of the internal control framework applied at Group Head Office and major operating subsidiary level measured against HSBC benchmarks, which cover all internal controls, both financial and non-financial; semi-annual confirmations from chief executives of principal subsidiary companies as to whether there have been any material losses, contingencies or uncertainties caused by weaknesses in internal controls; internal audit reports; external audit reports; prudential reviews; and regulatory reports. In addition, where unexpected losses have arisen or where incidents have occurred which indicate gaps in the control framework or in adherence to Group policies, the Group Audit Committee has reviewed special reports, prepared at the instigation of management, which analyse the cause of the issue, the lessons learned and the actions proposed by management to address the issue.



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HSBC HOLDINGS PLC

**Report of the Directors: Governance** (continued)**Board of Directors > Directors' interests / Employees**

The Directors, through the Group Audit Committee, have conducted an annual review of the effectiveness of HSBC's system of internal control covering all material controls, including financial, operational and compliance controls and risk management systems. The Group Audit Committee has received confirmation that management has taken or is taking the necessary action to remedy any failings or weaknesses identified through the operation of HSBC's framework of controls.

**Directors' interests**

Pursuant to the requirements of the UK Listing Rules and according to the register maintained by HSBC Holdings pursuant to section 352 of the Securities and Futures Ordinance of Hong Kong, the Directors of HSBC Holdings at the year-end had the following interests, all beneficial unless otherwise stated, in the shares and loan capital of HSBC and its associated corporations:

HSBC Holdings ordinary shares of US\$0.50

At 31 December 2007

	At 1 January 2007	Beneficial owner	Child under 18 or spouse	Trustee	Jointly with another person	Controlled corporation	Total interests <sup>1</sup>
J D Coombe	39,799	12,528	□	33,7992	□	□	46,327
Baroness Dunn	176,525	155,014	□	28,6502	□	□	183,664
D J Flint	104,947	83,467	□	29,3143	□	□	112,781
W K L Fung	328,000	328,000	□	□	□	□	328,000
M F Geoghegan	113,525	385,189	□	□	□	□	385,189
S K Green	401,796	491,297	□	□	45,355	□	536,652
J W J Hughes-Hallett	1,668,986	□	□	554,4352	□	□	554,435
Sir Brian Moffat	12,149	□	□	□	17,783	□	17,783
Sir Mark Moody-Stuart	10,840	5,000	840	5,0002	□	□	10,840
G Morgan	□	50,000	□	□	□	□	50,000
S W Newton	5,631	5,903	□	□	□	50,949	56,852
S M Robertson	131,976	5,317	□	93,0002	□	□	98,317
Sir Brian Williamson	17,281	23,164	□	□	□	□	23,164

1 Each of the total interests represents less than 0.02 per cent of the shares in issue. Details of executive Directors' other interests in HSBC Holdings ordinary shares of US\$0.50 arising from employee share plans are set out in the Directors' Remuneration Report on pages 330 to 332. At 31 December 2007, the aggregate interests under the Securities and Futures Ordinance of Hong Kong of D J Flint, M F Geoghegan and S K Green in HSBC Holdings ordinary shares of US\$0.50, including interests arising through employee share plans are: D J Flint □ 877,404; M F Geoghegan □ 1,509,480; and S K Green □ 1,710,886.

2 Non-beneficial.

3 *Non-beneficial interest in 9,772 HSBC Holdings ordinary shares of US\$0.50.*

M F Geoghegan has an interest as beneficial owner in 280,000 ordinary shares of HK\$5.00 each in Hang Seng Bank (representing less than 0.02 per cent of the shares in issue), which he acquired during the year.

S K Green has an interest as beneficial owner in 75,000 of HSBC Holdings plc 5½ per cent Subordinated Notes 2009 which he held throughout the year.

As a Director of HSBC Private Banking Holdings (Suisse), S K Green has an interest as beneficial owner in one share of CHF1,000 in that company (representing less than 0.01 per cent of the shares in issue), which he held throughout the year. S K Green has waived his rights to receive dividends on the share and has undertaken to transfer the share to HSBC on ceasing to be a Director of HSBC Private Banking Holdings (Suisse).

As Directors of HSBC France, S K Green and M F Geoghegan each have an interest as beneficial owner in one share of 5 in that company (representing less than 0.01 per cent of the shares in issue), which they held throughout the year. The Directors have waived their rights to receive dividends on these shares and have undertaken to transfer these shares to HSBC on ceasing to be Directors of HSBC France.

No Directors held any short positions as defined in the Securities and Futures Ordinance of Hong Kong in the shares and loan capital of HSBC and its associated corporations. Save as stated above and in the Directors' Remuneration Report, none of the Directors had an interest in any shares or debentures of HSBC or any associated corporation at the beginning or at the end of the year, and none of the Directors or members of their immediate family was

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awarded or exercised any right to subscribe for any shares or debentures in any HSBC corporation during the year.

Since the end of the year, the interests of each of the following Directors have increased by the number of HSBC Holdings ordinary shares shown against their name:

*HSBC Holdings ordinary shares of US\$0.50*

	<b>Beneficial owner</b>	<b>Jointly with another person</b>	<b>Beneficiary of a trust</b>	<b>Controlled corporation</b>
J D Coombe	127 <sup>1</sup>	□	□	□
Baroness Dunn	506 <sup>1</sup>	□	□	□
D J Flint	882 <sup>2</sup>	296 <sup>1</sup>	7,705 <sup>3</sup>	□
M F Geoghegan	2,286 <sup>1</sup>	□	11,361 <sup>3</sup>	□
S K Green	4,825 <sup>4</sup>	□	11,836 <sup>3</sup>	□
Sir Brian Moffat	179 <sup>1</sup>	□	□	□
G Morgan	505 <sup>1</sup>	□	□	□
S W Newton	60 <sup>1</sup>	□	□	515 <sup>1</sup>
S M Robertson	53 <sup>1</sup>	□	□	□
Sir Brian Williamson	234 <sup>1</sup>	□	□	□

1 *Scrip dividend.*

2 *Comprises scrip dividend on shares held as beneficial owner (779 shares), the acquisition of shares in the HSBC Holdings UK Share Ownership Plan through regular monthly contributions (33 shares), the automatic reinvestment of dividend income on shares held in the plan (14 shares) and by the automatic reinvestment of dividend income by an Individual Savings Account and Personal Equity Plan manager (56 shares).*

3 *Scrip dividend on conditional awards held under The HSBC Share Plan and the HSBC Holdings Restricted Share Plan 2000.*

4 *Comprises scrip dividend on shares held as beneficial owner (4,778 shares), the acquisition of shares in the HSBC Holdings UK Share Ownership Plan through regular monthly contributions (33 shares) and the automatic reinvestment of dividend income on shares held in the plan (14 shares).*

W S H Laidlaw had beneficial and non-beneficial interests in 20,000 and 4,500 HSBC Holdings ordinary shares respectively, on 1 January 2008, the date he was appointed a Director of HSBC Holdings.

V H C Cheng had beneficial interests in 244,539 HSBC Holdings ordinary shares and 408,022 conditional long-term incentive awards of Performance Shares on 1 February 2008, the date he was appointed a Director of HSBC Holdings.

There have been no other changes in the share and loan capital interests of the Directors until the date of this Report. Any subsequent changes up to the last practicable date before the publication of the *Notice of Annual General Meeting* will be set out in the notes to that Notice.

At 31 December 2007, Directors and Senior Management held, in aggregate, beneficial interests in 12,849,034 HSBC Holdings ordinary shares (0.1 per cent of the issued ordinary shares).

At 31 December 2007, executive Directors and Senior Management held, in aggregate, options to subscribe for 58,795 HSBC Holdings ordinary shares under the HSBC Holdings Executive Share Option Scheme and HSBC Holdings savings-related share option plans. These options are exercisable between 2008 and 2013 at prices ranging from £5.3496 to £7.6736 per share.

## Employees

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At 31 December 2007, HSBC's customers were served by 330,000 full and part-time employees worldwide, compared with 312,000 at 31 December 2006 and 284,000 at 31 December 2005. The main centres of employment are the UK with approximately 56,700 employees; the US 43,000; India 33,000; Hong Kong 29,000; Brazil 27,000; Mexico 23,000 and France 15,000. HSBC negotiates with recognised unions. The highest concentrations of union membership are in Argentina, Brazil, Colombia, Egypt, France, Germany, Jordan, Lebanon, Malaysia, Malta, Mexico, the Philippines, Singapore and the UK. It is HSBC's policy to maintain well-developed communications and consultation programmes and there have been no material disruptions to its operations from labour disputes during the past five years.

HSBC continues to develop the capabilities of its people. Formal policies and structures are in place to provide career development and training for all employees, with particular emphasis on increasing international mobility to enrich the diversity of the employees' experience. HSBC's talent strategy, which focuses on the development of leadership capability and smooth succession planning, continues. This is being achieved through mutual and open dialogue and planned development from graduate through to senior management levels.



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HSBC HOLDINGS PLC

## Report of the Directors: Governance (continued)

*Employees > Involvement / Disabled persons / Remuneration policy / Share plans*

HSBC continues to be committed to creating a diverse and inclusive work environment reflective of its customer base, international workforce, and communities in which it operates. It has a Group-wide strategy that aims to improve gender, ethnicity and age diversity to ensure the long-term sustainability of the organisation. There is particular focus on increasing gender and ethnic diversity at senior management levels. Diversity initiatives are implemented at a country level taking local and national laws into account. Employee network groups and mentoring programmes are promoted and established where possible to facilitate open discussion of workplace issues for employees belonging to minority groups, and to foster an environment that celebrates diversity.

HSBC recognises its role as an employer in a wider context and is committed to employee health issues, promoting employee involvement in community and not-for-profit organisations and providing flexible working opportunities. As a responsible employer and corporate citizen, HSBC recognises the need to address the issues raised by HIV/AIDS in the workplace and, in 2007, launched a HIV/AIDS policy. The policy defines the approach and minimum standards to be achieved by HSBC entities around the world. Key principles include non-discrimination and confidentiality, voluntary testing, commitment to prevention, education, awareness, care and support. To coincide with the launch of the Group policy an e-learning module and a dedicated intranet site was established to provide education on the important issues surrounding HIV/AIDS.

HSBC considers its people to be fundamental to its past and future success. In its pursuit of making HSBC the best place to work, HSBC maintains an ongoing dialogue with employees, and looks to understand how they are motivated and engaged. In 2007, HSBC conducted its first Global People Survey which comprised questions designed to measure employee engagement levels consistently across the Group. The survey covered HSBC's permanent global workforce, and responses were received from almost 290,000 employees, a significant response rate of 88 per cent. Questions were summarised under 12 dimensions. On all of the dimensions, employees rated HSBC above external global norms. Particular areas of strength were HSBC's brand reputation, its commitment to corporate sustainability and the quality of its direct managers. HSBC has communicated the results and key action plans are being developed to improve engagement. Following the success of the first survey, plans are underway for the second survey in 2008.

### Employee involvement

HSBC values open communication with its employees. Employees are encouraged to discuss operational and strategic issues, and ways of improving performance, with their line managers. Open communication throughout the organisation is encouraged and opportunities to share individual perspectives are created through networking events, management blogs, international assignments and learning and development programmes. Information is regularly given to employees about employment matters and the financial and economic factors affecting HSBC's performance. This is communicated via management channels, internal seminars, training programmes, in-house magazines and an intranet site accessible to the majority of HSBC's employees worldwide.

### Employment of disabled persons

HSBC believes in providing equal opportunities to all employees. The employment of disabled persons is included in this commitment and the recruitment, training, career development and promotion of disabled persons is based on the aptitudes and abilities of the individual. Should employees become disabled during employment, every effort is made to continue their employment and, if necessary, appropriate training is provided.

**Remuneration policy**

As the quality and commitment of its human capital is deemed fundamental to HSBC's success, the Board's stated strategy is to attract, retain and motivate the very best people.

In a business that is based on trust and relationships, HSBC's broad policy is to recruit those who are committed to making a long-term career with the organisation since trust and relationships are built over time.

Remuneration is an important component in people's decisions on which company to join and to stay with, but it is not the overriding one; it is HSBC's experience that people are attracted to, an organisation with strong values, one which is meritocratic and competitive and which offers transparent and interesting career development.

In line with the overall principles applied by the Remuneration Committee as described on page 322 in the Directors' Remuneration Report:

- employees' salaries are reviewed annually in the

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context of individual and business performance, market practice, internal relativities and competitive market pressures. Allowances and benefits are largely determined by local market practice;

- employees participate in various variable pay arrangements. Discretionary variable pay plans will normally make reference to the achievement of objectives which are ultimately aligned to those at the Group level, and which typically cover financial, customer, process and people targets. These targets typically include revenue growth, expense control, customer recommendation, employee engagement, adherence to HSBC's ethical standards, lending guidelines, internal controls and procedures to maintain a strong and secure operating platform. Actual levels of pay will depend on the performance of constituent businesses, the individuals concerned and competitive market practice;
- HSBC has a long history of paying close attention to its customers in order to provide value for both customers and shareholders. This has been achieved by ensuring that the interests of HSBC and its employees are aligned with those of its shareholders and that HSBC's approach to risk management serves the interests of all. Accordingly, employees are encouraged to participate in the success they help to create, through the HSBC Holdings savings-related share option plans and local share ownership and profit sharing arrangements.

### **Employee share plans**

To help align the interests of employees with those of shareholders, share options are granted under all-employee share plans and discretionary awards of Performance Shares and Restricted Shares are made under The HSBC Share Plan. There have been no awards of discretionary share options since 30 September 2005.

Set out on pages 309 to 317 are particulars of outstanding employee share options, including those held by employees working under employment contracts that are regarded as "continuous contracts" for the purposes of the Hong Kong Employment Ordinance. The options were granted at nil consideration. No options have been granted to substantial shareholders, suppliers of goods or services, or in excess of the individual limit for each share plan. No options were cancelled during the year.

Employee share plans are subject to the following limits on the number of HSBC Holdings ordinary shares that may be subscribed for. In any 10-year period not more than 10 per cent of the HSBC Holdings ordinary shares in issue from time to time (approximately 1,187 million HSBC Holdings ordinary shares at 3 March 2008) may in aggregate become issuable pursuant to the grant of options or be issued other than pursuant to options under all-employee share plans. In any 10-year period not more than 5 per cent of the HSBC Holdings ordinary shares in issue from time to time (approximately 593 million HSBC Holdings ordinary shares on 3 March 2008) may in aggregate be put under option under The HSBC Share Plan or be issuable pursuant to the HSBC Holdings Group Share Option Plan, the HSBC Executive Share Option Scheme, the HSBC Holdings Restricted Share Plan 2000 or The HSBC Share Plan. The number of HSBC Holdings ordinary shares that may be issued on exercise of all options granted on or after 27 May 2005 under The HSBC Share Plan and any other plans must not exceed 1,119,000,000 HSBC Holdings ordinary shares. Under the HSBC Holdings savings-related share option plans, The HSBC Share Plan, HSBC Holdings Group Share Option Plan and the HSBC Holdings Executive Share Option Scheme there were options outstanding over 260,714,579 HSBC Holdings ordinary shares at 31 December 2007. Particulars of options over HSBC Holdings shares held by Directors of HSBC Holdings are set out on page 331 of the Directors' Remuneration Report.

The effect on earnings per share of granting share options and share awards is shown in diluted earnings per share on the face of the consolidated income statement, with further details disclosed in Note 13 on the Financial Statements. The effect on basic earnings per share of dilutive share options and share awards would be to dilute it by 1.2 per cent.

### **All-employee share option plans**

The HSBC Holdings Savings-Related Share Option Plan and the HSBC Holdings Savings-Related Share Option Plan: International are all-employee share plans under which eligible HSBC employees (those employed within the Group on the first working day of the year of grant) may be granted options to acquire HSBC Holdings ordinary shares. Employees may make contributions of up to £250 (or equivalent) each month over a period of one, three or five years which may be used on the first, third or fifth anniversary of the commencement of the

relevant savings contract, at the employee's election, to exercise the options. Alternatively, the employee

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HSBC HOLDINGS PLC

**Report of the Directors: Governance** (continued)*Employees > Share plans*

may elect to have the savings, plus (where applicable) any interest or bonus, repaid in cash. Options granted over a one-year period will be exercisable within three months following the first anniversary of the commencement of the savings contract. Options granted over three or five-year periods will be exercisable within six months following the third or fifth anniversary of the commencement of the relevant savings contract. In the case of redundancy, retirement on grounds of injury or ill health, retirement at or after normal retirement age, the transfer of the employing business to another party, or a change of control of the employing company, options may be exercised before completion of the relevant savings contract.

Under the HSBC Holdings Savings-Related Share Option Plan and the HSBC Holdings Savings-Related Share Option Plan: International the option exercise price is determined by reference to the average market value of the ordinary shares on the

five business days immediately preceding the invitation date, then applying a discount of 20 per cent (except for the one-year options awarded under the US sub-plan where a 15 per cent discount is applied). The exercise period of the options awarded under all-employee share plans may be advanced to an earlier date in certain circumstances, for example on retirement, and may be extended in certain circumstances, for example on the death of a participant, the executors may exercise the option up to six months beyond the normal exercise period. The closing price per HSBC Holdings ordinary share on 24 April 2007, the day before options were awarded in 2007 under the HSBC Holdings Savings-Related Share Option Plan and the HSBC Holdings Savings-Related Share Option Plan: International, was £9.21. The all-employee share option plans will terminate on 27 May 2015 unless the Directors resolve to terminate the plans at an earlier date.

**HSBC Holdings Savings-Related Share Option Plan***HSBC Holdings ordinary shares of US\$0.50*

Date of award	Exercise price (£)	Exercisable from	Exercisable until	Options at 1 January 2007	Options awarded during year	Options exercised during <sup>1</sup> year	Options lapsed during year	Options at 31 December 2007
11 Apr 2001	6.7536	1 Aug 2006	31 Jan 2007	59,421	□	45,047	14,374	□
2 May 2002	6.3224	1 Aug 2007	31 Jan 2008	3,552,436	□	3,404,960	60,713	86,763
23 Apr 2003	5.3496	1 Aug 2006	31 Jan 2007	177,912	□	131,858	46,054	□
23 Apr 2003	5.3496	1 Aug 2008	31 Jan 2009	11,001,155	□	164,054	434,148	10,402,953
21 Apr 2004	6.4720	1 Aug 2007	31 Jan 2008	3,110,196	□	2,862,811	114,418	132,967
21 Apr 2004	6.4720	1 Aug 2009	31 Jan 2010	5,295,786	□	46,221	308,473	4,941,092
	6.6792	1 Aug 2008	31 Jan 2009	3,959,600	□	50,595	386,135	3,522,870

24 May 2005									
24 May 2005	6.6792	1 Aug 2010	31 Jan 2011	5,329,930	□	25,815	365,684	4,938,431	
26 Apr 2006	7.6736	1 Aug 2009	31 Jan 2010	4,653,146	□	20,423	815,325	3,817,398	
26 Apr 2006	7.6736	1 Aug 2011	31 Jan 2012	3,550,685	□	3,747	484,766	3,062,172	
25 Apr 2007	7.0872	1 Aug 2010	31 Jan 2011		□	6,166,897	407	399,118	5,767,372
25 Apr 2007	7.0872	1 Aug 2012	31 Jan 2013		□	4,228,735	206	153,058	4,075,471

1 The weighted average closing price of the shares immediately before the dates on which options were exercised was £9.12.

### **HSBC Holdings Savings-Related Share Option Plan: International**

To encourage greater participation in the HSBC Holdings Savings-Related Share Option Plan: International, two amendments were approved at the 2005 Annual General Meeting. The first was the introduction of the facility to save and have option

prices expressed in US dollars, Hong Kong dollars and euros as well as in pounds sterling. Where applicable, the US dollars, Hong Kong dollars and euro exercise prices are converted from the sterling exercise price at the applicable exchange rate on the working day preceding the relevant invitation date. The second amendment was to provide the choice of options over one year in addition to three and five year terms.

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*HSBC Holdings ordinary shares of US\$0.50*

Date of award	Exercise price	Exercisable from	Exercisable until	Options at 1 January 2007	Options awarded during year	Options exercised during <sup>1</sup> year	Options lapsed during year	Options at 31 December 2007
(£)								
11 Apr 2001	6.7536	1 Aug 2006	31 Jan 2007	40,853	□	11,473	29,380	□
2 May 2002	6.3224	1 Aug 2007	31 Jan 2008	1,063,521	□	832,209	192,140	39,172
23 Apr 2003	5.3496	1 Aug 2008	31 Jan 2009	10,488	□	□	□	10,488
8 May 2003	5.3496	1 Aug 2006	31 Jan 2007	310,378	□	120,785	189,593	□
8 May 2003	5.3496	1 Aug 2008	31 Jan 2009	5,827,034	□	77,890	680,642	5,068,502
21 Apr 2004	6.4720	1 Aug 2007	31 Jan 2008	47,070	□	15,770	155	31,145
21 Apr 2004	6.4720	1 Aug 2009	31 Jan 2010	12,365	□	□	□	12,365
10 May 2004	6.4720	1 Aug 2007	31 Jan 2008	8,613,295	□	7,394,632	968,135	250,528
10 May 2004	6.4720	1 Aug 2009	31 Jan 2010	2,953,476	□	30,234	369,055	2,554,187
24 May 2005	6.6792	1 Aug 2008	31 Jan 2009	10,956,064	□	141,018	1,379,824	9,435,222
24 May 2005	6.6792	1 Aug 2010	31 Jan 2011	3,743,916	□	19,417	320,921	3,403,578
26 Apr 2006	7.6736	1 Aug 2007	31 Oct 2007	860,609	□	727,512	101,439	31,658
26 Apr 2006	7.6736	1 Aug 2009	31 Jan 2010	2,324,779	□	8,155	512,297	1,804,327
26 Apr 2006	7.6736	1 Aug 2011	31 Jan 2012	518,112	□	367	111,002	406,743
25 Apr 2007	7.0872	1 Aug 2008	31 Oct 2008	□	1,647,064	26	103,072	1,543,966
25 Apr 2007	7.0872	1 Aug 2010	31 Jan 2011	□	3,573,175	287	136,795	3,436,093
25 Apr 2007	7.0872	1 Aug 2012	31 Jan 2013	□	1,019,913	□	44,150	975,763
(US\$)								
26 Apr 2006	14.1621 <sup>2</sup>	1 Aug 2007	31 Oct 2007	591,818	□	493,725	98,093	□
26 Apr 2006	13.3290	1 Aug 2007	31 Oct 2007	112,660	□	92,917	14,470	5,273
26 Apr 2006	13.3290	1 Aug 2009	31 Jan 2010	1,749,146	□	7,220	266,055	1,475,871
26 Apr 2006	13.3290	1 Aug 2011	31 Jan 2012	478,476	□	1,412	91,099	385,965
25 Apr 2007	14.7478 <sup>2</sup>	1 Aug 2008	31 Oct 2008	□	729,015	□	57,566	671,449
25 Apr 2007	13.8803	1 Aug 2008	31 Oct 2008	□	347,176	□	9,396	337,780

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25 Apr 2007	13.8803	1 Aug 2010	31 Jan 2011		□	2,817,545	232	129,390	2,687,923
25 Apr 2007	13.8803	1 Aug 2012	31 Jan 2013		□	804,104	362	43,083	760,659
(□)									
26 Apr 2006	11.0062	1 Aug 2007	31 Oct 2007	42,046		□	38,928	2,271	847
26 Apr 2006	11.0062	1 Aug 2009	31 Jan 2010	188,857		□		12,057	176,800
26 Apr 2006	11.0062	1 Aug 2011	31 Jan 2012	39,570		□		4,075	35,495
25 Apr 2007	10.4217	1 Aug 2008	31 Oct 2008		□	128,427		5,795	122,632
25 Apr 2007	10.4217	1 Aug 2010	31 Jan 2011		□	376,440		14,598	361,842
25 Apr 2007	10.4217	1 Aug 2012	31 Jan 2013		□	128,871		3,015	125,856
(HK\$)									
26 Apr 2006	103.4401	1 Aug 2007	31 Oct 2007	1,295,846		□	1,160,815	133,070	1,961
26 Apr 2006	103.4401	1 Aug 2009	31 Jan 2010	4,255,761		□	16,734	347,873	3,891,154
26 Apr 2006	103.4401	1 Aug 2011	31 Jan 2012	1,110,391		□	1,516	84,033	1,024,842
25 Apr 2007	108.4483	1 Aug 2008	31 Oct 2008		□	2,225,766	367	117,273	2,108,126
25 Apr 2007	108.4483	1 Aug 2010	31 Jan 2011		□	4,561,313	826	79,232	4,481,255
25 Apr 2007	108.4483	1 Aug 2012	31 Jan 2013		□	1,350,798	317	18,407	1,332,074

- 1 *The weighted average closing price of the shares immediately before the dates on which options were exercised was £9.13.*
- 2 *Exercisable at a 15 per cent discount to the average market value of the ordinary shares on the five business days immediately preceding the invitation date.*



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HSBC HOLDINGS PLC

## Report of the Directors: Governance (continued)

*Employees > Share plans / Subsidiary company share plans*

### Discretionary Share Plans

Note 10 on the Financial Statements gives detail on share-based payments, including awards of Performance Shares and Restricted Shares made in 2007.

The HSBC Share Plan was approved at the 2005 Annual General Meeting. Awards of Performance Shares are made under this Plan to executive Directors and other senior executives. The performance conditions for awards of Performance Shares are described under Long-term incentive plan on page 324.

Awards of Performance Shares are directed to those senior executives who can influence corporate performance such as members of the Group Management Board.

Awards of Restricted Shares are typically made to other employees based on individual performance, business performance and competitive market practice.

Restricted Share awards define the number of shares to which the employee will become entitled, generally between one and three years from the date of the award, subject to the individual remaining in employment. All awards of Performance Shares and Restricted Shares will be satisfied by the transfer of existing shares.

Since 2005, awards of share options under The HSBC Share Plan have only been granted in very limited circumstances. There may be particular circumstances in the future where option grants could be appropriate. No options were awarded under The HSBC Share Plan in 2007.

Prior to 2005, discretionary awards of share options, with vesting subject to the attainment of a predetermined TSR performance condition, were made to employees at all levels of HSBC.

The vesting of these options was subject to the attainment of pre-determined relative TSR performance criteria, except in HSBC France (which was acquired in 2000) where performance criteria were phased in. Under the HSBC Holdings Group Share Option Plan, the maximum grant of options which could be granted to an employee in any one

year (together with the Performance Share awards under the HSBC Holdings Restricted Share Plan 2000) was 150 per cent (or in exceptional circumstances 225 per cent) of the employee's annual salary at the date of grant plus any bonus paid in the previous year.

Under the HSBC Executive Share Option scheme the maximum value of options which could be granted to an employee in any one year was four times the employee's relevant earnings. Subject to the attainment of the relative TSR performance condition where applicable, options are generally exercisable between the third and the tenth anniversary of the date of grant. Employees of a subsidiary that is sold or transferred out of HSBC may exercise options awarded under the HSBC Group Share Option Plan or the HSBC Holdings Executive Share Option Scheme within six or twelve months respectively of the sale or transfer, regardless of whether the performance condition is met.

The maximum value of options that may be granted to an employee in any one year under The HSBC Plan (when taken together with any Performance Share award made under The HSBC Share Plan) is 700 per cent of the employee's annual salary at the date of grant.

The exercise price of options granted under The HSBC Share Plan, and previously under the HSBC Holdings Group Share Option Plan, is the higher of the average market value of the ordinary shares on the five business days prior to the grant of the option or the market value of the ordinary shares on the date of grant of the option. The exercise price of options granted under the HSBC Holdings Executive Share Option Scheme was the market value of the ordinary shares on the business day prior to the grant of the option. The HSBC Share Plan will terminate on 27 May 2015 unless the Directors resolve to terminate the Plan at an earlier date.

The exercise period of the options awarded under discretionary share incentive plans may be advanced to an earlier date in certain circumstances, for example on retirement, or on the death of a participant, options may be exercised up to 12 months beyond the normal exercise period.

[Back to Contents](#)**HSBC Holdings Executive Share Option Scheme<sup>1</sup>**HSBC Holdings ordinary shares of  
US\$0.50

Date of award	Exercise price (£)	Exercisable from	Exercisable until	Options at 1 January 2007	Options exercised during year <sup>2</sup>	Options lapsed during year	Options at 31 December 2007
24 Mar 1997	5.0160	24 Mar 2000	24 Mar 2007	188,074	188,053	21	□
12 Aug 1997	7.7984	12 Aug 2000	12 Aug 2007	9,000	□	9,000	□
16 Mar 1998	6.2767	16 Mar 2001	16 Mar 2008	678,434	243,293	7,500	427,641
29 Mar 1999	6.3754	3 Apr 2002	29 Mar 2009	11,808,970	1,829,283	184,774	9,794,913
10 Aug 1999	7.4210	10 Aug 2002	10 Aug 2009	100,058	9,000	□	91,058
31 Aug 1999	7.8710	31 Aug 2002	31 Aug 2009	4,000	□	□	4,000
3 Apr 2000	7.4600	3 Apr 2003	3 Apr 2010	9,248,569	1,108,267	219,372	7,920,930

1 The HSBC Holdings Executive Share Option Scheme expired on 26 May 2000. No options have been granted under the Scheme since that date.

2 The weighted average closing price of the shares immediately before the dates on which options were exercised was £9.15.

**HSBC Holdings Group Share Option Plan<sup>1</sup>**HSBC Holdings ordinary shares of  
US\$0.50

Date of award	Exercise price (£)	Exercisable from	Exercisable until	Options at 1 January 2007	Options exercised during year <sup>2</sup>	Options lapsed during year	Options at 31 December 2007
4 Oct 2000	9.6420	4 Oct 2003	4 Oct 2010	321,176	□	14,535	306,641
23 Apr 2001	8.7120	23 Apr 2004	23 Apr 2011	29,400,469	1,450,759	783,613	27,166,097
30 Aug 2001	8.2280	30 Aug 2004	30 Aug 2011	179,193	22,175	6,538	150,480
7 May 2002	8.4050	7 May 2005	7 May 2012	32,501,697	2,176,110	762,898	29,562,689
30 Aug 2002	7.4550	30 Aug 2005	30 Aug 2012	361,600	2,500	4,500	354,600
2 May 2003	6.9100	2 May 2006	2 May 2013	34,541,586	4,584,914	999,377	28,957,295
29 Aug 2003	8.1300	29 Aug 2006	29 Aug 2013	445,894	30,250	20,860	394,784
3 Nov 2003	9.1350	3 Nov 2006	3 Nov 2013	4,885,800	□	816,000	4,069,800
30 Apr 2004	8.2830	30 Apr 2007	30 Apr 2014	58,455,504	84,941	4,527,677	53,842,886
27 Aug 2004	8.6500	27 Aug 2007	27 Aug 2014	332,470	□	20,470	312,000
20 Apr 2005	8.3620	30 Apr 2008	20 Apr 2015	7,360,795	□	265,500	7,095,295

1 The HSBC Holdings Group Share Option Plan expired on 26 May 2005. No options have been granted under the Plan since that date.

2

The weighted average closing price of the shares immediately before the dates on which options were exercised was £9.23.

**The HSBC Share Plan**

HSBC Holdings  
ordinary shares of  
US\$0.50

Date of award	Exercise price (£)	Exercisable from	Exercisable until	Options at 1 January 2007	Options exercised during year	Options lapsed during year	Options at 31 December 2007
21 Jun 2005	8.794	21 Jun 2008	21 Jun 2009	552,526	□	103,071	449,455
30 Sep 2005	9.170	30 Sep 2008	30 Sep 2015	74,985	□	□	74,985

Subsidiary company share plans

HSBC France and subsidiary company

When it was acquired in 2000, HSBC France and one of its subsidiary companies, HSBC Private Bank France, operated employee share option plans under

which options could be granted over their respective shares. No further options will be granted under either of these companies' plans. The following are details of options to acquire shares in HSBC France and HSBC Private Bank France.

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HSBC HOLDINGS PLC

**Report of the Directors: Governance** (continued)*Employees > Subsidiary company share plans***HSBC France***shares of [5]*

Date of award	Exercise price (€)	Exercisable from	Exercisable until	Options at 1 January 2007	Options exercised during <sup>1</sup> year	Options lapsed during year	Options at 31 December 2007 <sup>1</sup>
7 May 1997	37.05	7 Jun 2000	7 May 2007	66,000	66,000	□	□
29 Apr 1998	73.48	7 Jun 2000	29 Apr 2008	192,154	91,775	□	100,379
7 Apr 1999	81.71	7 Jun 2000	7 Apr 2009	383,602	79,200	□	304,402
12 Apr 2000	142.50	1 Jan 2002	12 Apr 2010	646,125	43,875	□	602,250

<sup>1</sup> Following exercise of the options, the HSBC France shares will be exchanged for HSBC Holdings ordinary shares in the same ratio as for the acquisition of HSBC France (13 HSBC Holdings ordinary shares for each HSBC France share). At 31 December 2007, The HSBC Holdings Employee Benefit Trust 2001 (No. 1) held 11,665,278 HSBC Holdings ordinary shares which may be exchanged for HSBC France shares arising from the exercise of these options.

**HSBC Private Bank France***shares of [2]*

Date of award	Exercise price (€)	Exercisable from	Exercisable until	Options at 1 January 2007	Options exercised during <sup>1</sup> year	Options lapsed during year	Options at 31 December 2007 <sup>1</sup>
21 Dec 1999	10.84	21 Dec 2000	21 Dec 2009	57,130	23,880	□	33,250
9 Mar 2000	12.44	27 Jun 2004	31 Dec 2010	27,626	7,000	□	20,626
15 May 2001	20.80	15 May 2002	15 May 2011	155,025	13,500	□	141,525
1 Oct 2002	22.22	2 Oct 2005	1 Oct 2012	163,075	17,500	□	145,575

<sup>1</sup> Following exercise of the options, the HSBC Private Bank France shares will be exchanged for HSBC Holdings ordinary shares in the ratio of 1.83 HSBC Holdings ordinary shares for each HSBC Private Bank France share. At 31 December 2007, The CCF Employee Benefit Trust 2001 held 955,952 HSBC Holdings ordinary shares which may be exchanged for HSBC Private Bank France shares arising from the exercise of these options.

**HSBC Finance and its subsidiaries**

Following the acquisition of HSBC Finance in 2003, all outstanding options and equity-based awards over HSBC Finance common shares were converted into rights to receive HSBC Holdings ordinary shares in the same ratio as the share exchange offer for the acquisition of HSBC Finance (2.675 HSBC Holdings ordinary shares for each HSBC Finance common share) and the exercise prices per share were adjusted accordingly. No further options will be granted under any of these plans.

All outstanding options and other equity-based awards over HSBC Finance common shares granted before 14 November 2002, being the date the

transaction was announced, vested on completion of the acquisition. Options and equity-based awards granted on or after 14 November 2002 are exercisable on their original terms, save that they have been adjusted to reflect the exchange ratio.

The following are details of options and equity-based awards to acquire shares in HSBC Holdings.

At 31 December 2007, the HSBC (Household) Employee Benefit Trust 2003 held 1,856,417 HSBC Holdings ordinary shares and 196,455 American Depositary Shares, each of which represents five HSBC Holdings ordinary shares, which may be used to satisfy the exercise of employee share options.

[Back to Contents](#)**HSBC Finance: 1996 Long-Term Executive Incentive Compensation Plan***HSBC Holdings ordinary shares of US\$0.50*

Date of award	Exercise price (US\$)	Exercisable from	Exercisable until	Options at 1 January 2007	Options exercised during <sup>1</sup> year	Options lapsed during year	Options at 31 December 2007
14 May 1997	11.29	14 May 1998	14 May 2007	100,315	□	100,315	□
10 Nov 1997	14.60	10 Nov 1998	10 Nov 2007	573,684	490,088	83,596	□
15 Jun 1998	17.08	15 Jun 1999	15 Jun 2008	802,500	802,500	□	□
1 Jul 1998	19.21	1 Jul 1999	1 Jul 2008	80,250	□	□	80,250
9 Nov 1998	13.71	9 Nov 1999	9 Nov 2008	2,020,741	1,179,175	□	841,566
17 May 1999	16.99	17 May 2000	17 May 2009	334,375	□	□	334,375
31 Aug 1999	13.96	31 Aug 2000	31 Aug 2009	337,051	36,113	□	300,938
8 Nov 1999	16.96	8 Nov 2000	8 Nov 2009	4,782,902	532,325	□	4,250,577
30 Jun 2000	15.70	30 Jun 2001	30 Jun 2010	26,846	□	□	26,846
8 Feb 2000	13.26	8 Feb 2001	8 Feb 2010	66,875	□	□	66,875
13 Nov 2000	18.40	13 Nov 2001	13 Nov 2010	6,349,114	620,600	□	5,728,514
12 Nov 2001	21.37	12 Nov 2002	12 Nov 2011	7,571,322	□	□	7,571,322
20 Nov 2002	10.66	20 Nov 2003 <sup>2</sup>	20 Nov 2012	3,125,202	670,904	□	2,454,298

1 *The weighted average closing price of the shares immediately before the dates on which options were exercised was £9.37.*

2 *25 per cent of the original award was exercisable on each of the first, second, third and fourth anniversaries of the date of award. The exercise period may be advanced to an earlier date in certain circumstances, e.g. retirement.*

**HSBC Finance: 1996 Long-Term Executive Incentive Compensation Plan<sup>1</sup>***HSBC Holdings ordinary shares of US\$0.50*

Date of award	Vesting <sup>2</sup> from	Vesting <sup>2</sup> until	Rights at 1 January 2007	Rights vested during <sup>3</sup> year	Rights lapsed during year	Rights at 31 December 2007
15 Nov 2002	15 Nov 2005	15 Nov 2007	2,409	1,517	892	□
20 Nov 2002	20 Nov 2005	20 Nov 2007	539,027	518,417	20,610	□
2 Dec 2002	2 Dec 2005	2 Dec 2007	3,123	1,339	□	1,784
16 Dec 2002	16 Dec 2005	16 Dec 2007	11,774	11,774	□	□
20 Dec 2002	20 Dec 2005	20 Dec 2007	88,286	88,286	□	□
2 Jan 2003	2 Jan 2006	2 Jan 2008	893	446	□	447
15 Jan 2003	15 Jan 2006	15 Jan 2008	20,959	10,479	□	10,480
3 Feb 2003	3 Feb 2006	3 Feb 2008	6,344	3,170	268	2,906
14 Feb 2003	14 Feb 2006	14 Feb 2008	98,265	49,131	□	49,134

3 Mar 2003	3 Mar 2006	3 Mar 2008	893	446	□	447
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- 1 Awards of Restricted Stock Rights which represent a right to receive shares for nil consideration if the employee remains in the employment of HSBC Finance at the date of vesting.
- 2 Restricted Stock Rights vest one third on each of the third, fourth and fifth anniversaries of the date of award. The exercise period may be advanced to an earlier date in certain circumstances, e.g. retirement.
- 3 The weighted average closing price of the shares immediately before the dates on which rights vested was £8.47.

**Beneficial Corporation: 1990 Non-Qualified Stock Option Plan**

HSBC Holdings ordinary shares of US\$0.50

Date of award	Exercise price (US\$)	Exercisable from	Exercisable until	Options at 1 January 2007	Options exercised during <sup>1</sup> year	Options lapsed during year	Options at 31 December 2007
14 Nov 1997	9.20	14 Nov 1998	14 Nov 2007	131,248	□	131,248	□
19 Nov 1997	9.39	19 Nov 1998	19 Nov 2007	309,225	309,225	□	□
1 Dec 1997	9.68	1 Dec 1998	1 Dec 2007	49,218	□	49,218	□

- 1 The weighted average closing price of the shares immediately before the dates on which options were exercised was £9.22.



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HSBC HOLDINGS PLC

**Report of the Directors: Governance** (continued)

*Employees > Subsidiary company share plans / Employee compensation*

**Beneficial Corporation: BenShares Equity Participation Plan**

*HSBC Holdings ordinary shares of US\$0.50*

Date of award	Exercise price (US\$)	Exercisable from	Exercisable until	Options at 1 January 2007	Options exercised during 1 year	Options lapsed during year	Options at 31 December 2007
31 Jan 1997	9.87	31 Jan 1998	31 Jan 2007	20,113	10,261	9,852	□
15 Nov 1997	11.04	15 Nov 1998	15 Nov 2007	36,407	32,837	3,570	□

1 *The weighted average closing price of the shares immediately before the dates on which options were exercised was £9.05.*

**Renaissance Holdings, Inc: Amended and Restated 1997 Incentive Plan**

*HSBC Holdings ordinary shares of US\$0.50*

Date of award	Exercise price (US\$)	Exercisable from	Exercisable until	Options at 1 January 2007	Options exercised during 1 year	Options lapsed during year	Options at 31 December 2007
31 Oct 1997	1.25	31 Oct 1998	31 Oct 2007	1,325	1,071	254	□
1 Jan 1998	1.25	1 Jan 1999	1 Jan 2008	1,424	□	□	1,424
1 Oct 1998	1.74	1 Oct 1999	1 Oct 2008	803	□	□	803
1 Jan 1999	2.24	1 Jan 2000	1 Jan 2009	5,024	□	□	5,024

1 *The weighted average closing price of the shares immediately before the dates on which options were exercised was £8.92.*

**Bank of Bermuda**

Following the acquisition of Bank of Bermuda in 2004, all outstanding options over Bank of Bermuda shares were converted into rights to receive HSBC Holdings ordinary shares based on the consideration of US\$40 for each Bank of Bermuda share and the average closing price of HSBC Holdings ordinary shares, derived from the London Stock Exchange Daily Official List, for the five business days preceding the closing date of the acquisition. No

further options will be granted under any of these plans.

All outstanding options over Bank of Bermuda shares vested on completion of the acquisition. The following are details of options to acquire shares in HSBC Holdings. At 31 December 2007, the HSBC (Bank of Bermuda) Employee Benefit Trust 2004 held 1,889,903 HSBC Holdings ordinary shares which may be used to satisfy the exercise of these options.

**Bank of Bermuda: Executive Share Option Plan 1997***HSBC Holdings ordinary shares of US\$0.50*

Date of award	Exercise price (US\$)	Exercisable from	Exercisable until	Options at 1 January 2007	Options exercised during <sup>1</sup> year	Options lapsed during year	Options at 31 December 2007
1 Jul 1998	9.61	1 Jul 1999	1 Jul 2008	67,813	□	□	67,813
23 Feb 1999	7.40	23 Feb 2000	23 Feb 2009	11,684	6,780	□	4,904
3 Aug 1999	7.10	3 Aug 2000	3 Aug 2009	9,331	1,697	□	7,634
4 Feb 2000	7.21	4 Feb 2001	4 Feb 2010	40,185	8,507	□	31,678
1 Jun 2000	7.04	1 Jun 2001	1 Jun 2010	61,649	□	□	61,649
31 Jul 2000	10.11	31 Jul 2001	31 Jul 2010	27,744	□	□	27,744
11 Jan 2001	14.27	11 Jan 2002	11 Jan 2011	161,829	107,886	□	53,943

<sup>1</sup> *The weighted average closing price of the shares immediately before the dates on which options were exercised was £8.95.*

[Back to Contents](#)**Bank of Bermuda: Share Option Plan 2000***HSBC Holdings ordinary shares of US\$0.50*

Date of award	Exercise price (US\$)	Exercisable from	Exercisable until	Options at 1 January 2007	Options exercised during <sup>1</sup> year	Options lapsed during year	Options at 31 December 2007
11 Jan 2001	14.27	11 Jan 2002	11 Jan 2011	134,857	□	□	134,857
6 Feb 2001	16.41	6 Feb 2002	6 Feb 2011	630,646	51,084	4,392	575,170
29 Mar 2001	15.39	29 Mar 2002	29 Mar 2011	270	□	□	270
16 Apr 2001	15.57	16 Apr 2002	16 Apr 2011	539	□	□	539
6 Jun 2001	18.35	6 Jun 2002	6 Jun 2011	8,091	□	□	8,091
16 Jul 2001	16.87	16 Jul 2002	16 Jul 2011	14,930	□	□	14,930
28 Aug 2001	15.39	28 Aug 2002	28 Aug 2011	13,486	□	□	13,486
26 Sep 2001	12.79	26 Sep 2002	26 Sep 2011	438,585	84,694	□	353,891
30 Jan 2002	15.60	30 Jan 2003	30 Jan 2012	1,226	□	□	1,226
5 Feb 2002	16.09	5 Feb 2003	5 Feb 2012	865,382	95,775	6,836	762,771
10 Jul 2002	15.84	10 Jul 2003	10 Jul 2012	12,260	□	□	12,260
4 Feb 2003	10.69	4 Feb 2004	4 Feb 2013	139,658	6,616	□	133,042
21 Apr 2003	11.85	21 Apr 2004	21 Apr 2013	20,840	14,007	□	6,833

1 The weighted average closing price of the shares immediately before the dates on which options were exercised was £9.08.

**Bank of Bermuda: Directors' Share Option Plan***HSBC Holdings ordinary shares of US\$0.50*

Date of award	Exercise price (US\$)	Exercisable from	Exercisable until	Options at 1 January 2007	Options exercised during year	Options lapsed during year	Options at 31 December 2007
22 Sep 1999	8.02	22 Sep 2000	22 Sep 2009	3,082	□	□	3,082
20 Sep 2000	11.31	20 Sep 2001	20 Sep 2010	4,046	□	□	4,046
28 Mar 2001	15.76	28 Mar 2002	28 Mar 2011	12,811	□	□	12,811
3 Apr 2002	16.01	3 Apr 2003	3 Apr 2012	24,520	□	□	24,520
30 Apr 2003	12.23	30 Apr 2004	30 Apr 2013	4,904	□	□	4,904

**Employee compensation and benefits**

Note 9 on the Financial Statements gives details about employee compensation and benefits including pension plans.

Set out below is information in respect of the five individuals (including a Director of HSBC Holdings) whose emoluments were the highest in HSBC for the year ended 31 December 2007.

**£000**

Basic salaries, allowances and benefits in kind	<b>2,797</b>
---	--------------

Pension contributions	<b>500</b>
Bonuses paid or receivable	<b>24,566</b>
	<hr/>
Total	<b>27,863</b>
	<hr/>
Total (US\$000)	<b>55,775</b>
	<hr/>

Their emoluments are within the following bands:

	<b>Number of Employees</b>
£3,700,001 □ £3,800,000	<b>1</b>
£4,400,001 □ £4,500,000	<b>1</b>
£4,700,001 □ £4,800,000	<b>1</b>
£4,900,001 □ £5,000,000	<b>1</b>
£9,900,001 □ £10,000,000	<b>1</b>

The aggregate remuneration of Directors and Senior Management for the year ended 31 December 2007 was US\$92,586,000.

The aggregate amount set aside or accrued to provide pension, retirement or similar benefits for Directors and Senior Management for the year ended 31 December 2007 was US\$2,027,455.

Executive Directors and members of Senior Management are generally subject to notice periods of up to 12 months and a normal retirement age of 65.

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HSBC HOLDINGS PLC

## Report of the Directors: Governance (continued)

*Corporate sustainability*

### Corporate sustainability

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Corporate sustainability is the term used at HSBC to describe the Group's approach to meeting a wide range of non-financial responsibilities which, although not generally enshrined as legal or regulatory requirements, constitute business practices expected of the Group by its stakeholders, including shareholders, customers and employees. Insofar as these expectations concern HSBC's impact on the long-term environmental, social and economic well-being of the world at large, corporate sustainability influences the Group's response to encouraging sustainable development. Previously, HSBC described these activities under the heading, "Corporate responsibility".

#### Investing in sustainability

HSBC seeks to meet society's expectations by managing all aspects of its business ethically, responsibly and in an increasingly sustainable way. The Group's key business values include a commitment to the highest personal standards of integrity at all levels, including honesty, transparency and fair dealing in all its business activities. In recent years HSBC has intensified its efforts to embed sustainability into the way it manages risk and business development opportunities. This acknowledges that HSBC's continuing financial success depends, in part, on its ability to identify and address non-financial considerations which are material to the business.

Recognising that HSBC's core financial services businesses have the potential to exert the most influence over sustainability issues, a Group Corporate Sustainability unit was formed in 2007 to work closely with individuals and businesses in all customer groups to help them to manage sustainability risks and to pursue opportunities in environmental markets worldwide.

Group Corporate Sustainability acts as a focal point for the management of HSBC's environmental and social initiatives. Environmental initiatives are directed primarily to issues arising from climate change, including its effect on energy production and usage, water management and biodiversity. Social initiatives are centred on community action to promote education as a lasting way of alleviating poverty. The Group Corporate Sustainability unit allows HSBC to join up its business development, risk management, business operations, community investment and reporting activities. The unit also works closely with Group Marketing to further embed sustainability into the brand; with Group Communications to ensure that sustainability

initiatives are communicated to internal and external audiences; and with Group Human Resources to integrate this area into employee engagement and talent management strategies. The unit reports directly to the Group Chairman.

HSBC aims for consistency in the implementation of its sustainability strategy across all Group businesses, and has identified four themes as relevant to its response to the United Nations Millennium Development Goals of resisting climate change, achieving water availability, protecting biodiversity and alleviating poverty. These themes are risk management (policies and processes); business development; operations (buildings, travel, suppliers and IT); and community investment (education and environment).

The Group's Sustainable Risk Management Unit has published policies laying down minimum standards for lending and investment covering relationships with clients in energy, forest land and products, freshwater infrastructure, mining and metals and the chemicals industry. Each policy focuses on how HSBC's involvement in these environmentally sensitive industries can contribute to sustainable development.

In recognition of its leadership in building responsible practices into the way it does business, HSBC moved from 7th to 4th in the Accountability Rating prepared by Accountability. HSBC continued to earn a high score of 95 and a triple-A rating in the Carbon Disclosure Project, a climate change index ranking FT500 corporations.

In 2005, HSBC was the first major banking organisation in the world to become carbon neutral. HSBC remains committed to reducing its own carbon emissions and helping to bring about a low-carbon economy.

HSBC created a Climate Change Centre of Excellence in 2007. The Centre's goal is to evaluate the implications of climate change for the HSBC Group, its Global Research division and relevant businesses. The Centre is HSBC's central source of climate knowledge, translating a wide range of expertise – from academic studies, think tanks and government regulations – into business opportunities for the bank and its clients. The Centre works closely with HSBC's Global Research sector heads and analysts on integrating the financial implications of climate change and relevant government regulations into their sectoral research. It also supports the implementation of HSBC's Carbon Finance Strategy, announced in June 2006, and advises a range of HSBC businesses for which climate change is increasingly important.

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In 2007, HSBC appointed Lord Stern, the renowned academic and former World Bank Chief Economist, as Special Adviser to the Chairman on Economic Development and Climate Change. Lord Stern is responsible for advising HSBC on economic development issues and the implications of climate change on the Group and its clients. His role includes:

- providing direct advice on specific strategic issues in emerging markets where the bank has aspirations to grow its business;
- advising on the socio-economic implications of climate change and representing HSBC on these issues;
- contributing to management development programmes, from graduate intake through to senior management development activities; and
- providing advice to major clients of the Group who seek to develop sustainable business strategies or other programmes relating to climate change and to economic development issues.

### **Community involvement**

HSBC has a longstanding commitment to supporting the communities in which it operates. In 2006, for example, the HSBC Global Education Trust launched "Future First", a five-year programme designed to help street children, children in care and orphans. HSBC's operations around the world collaborate with local charitable organisations to make a lasting and beneficial difference by supporting projects that bring these children into the mainstream of society. The programme complements HSBC's sustainable business development focus on poverty, for which a microfinance strategy was developed during 2006. To date, US\$2 million has been allocated to 80 projects in 30 countries. These projects will benefit 37,000 children.

In May 2007, the Group Chairman launched the HSBC Climate Partnership, committing US\$100 million over five years to fund the work of The Climate Group, Earthwatch Institute, Smithsonian Tropical Research Institute and WWF to inspire action by individuals, businesses and governments around the world on the challenge of climate change. The HSBC Climate Partnership, which will strengthen the Group's leadership position and help HSBC employees to use their business skills and climate change knowledge to build a more sustainable future, represents one of the largest single corporate donations to each of the charity partners and one of the largest employee engagement programmes by any organisation on climate change.

HSBC participated in the Prince of Wales's Accounting for Sustainability Project, which seeks to develop systems to help public and private sector organisations account more accurately for the wider social and environmental costs of their activities.

### **Health and safety**

The maintenance of appropriate health and safety standards throughout HSBC remains a key responsibility of all managers and HSBC is committed to managing actively all health and safety risks associated with its business. HSBC's objectives are to identify, remove, reduce or control material risks of fires and of accidents or injuries to employees and visitors.

Health and Safety Policies, Group standards and procedures are set by Group Corporate Real Estate and are implemented by Health, Safety and Fire Co-ordinators based in each country in which HSBC operates.

Despite the considerable international pressure on terrorist networks over the past few years, the global threat from terrorism persists. HSBC remains committed to maintaining its preparedness and to ensuring the highest standards of health and safety wherever in the world it operates.

Group Security provides regular risk assessments in areas of increased risk to assist management in judging the level of terrorist threat. In addition, Regional Security functions conduct regular security reviews to ensure measures to protect HSBC staff, buildings, assets and information are appropriate for the level of threat.

### **Supplier payment policy**

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HSBC Holdings subscribes to the Better Payment Practice Code for all suppliers, the four principles of which are: to agree payment terms at the outset and stick to them; to explain payment procedures to suppliers; to pay bills in accordance with any contract agreed with the supplier or as required by law; and to tell suppliers without delay when an invoice is contested and settle disputes quickly.

Copies of, and information about, the Code are available from: BERR Publications Orderline, Admail 528, London SW1W 8YT; and the internet at [www.payontime.co.uk/downloads/DTI\\_BPP\\_brochure.pdf](http://www.payontime.co.uk/downloads/DTI_BPP_brochure.pdf)

It is HSBC Holdings' practice to organise payment to its suppliers through a central accounts function operated by its subsidiary, HSBC Bank. Included in the balance with HSBC Bank is the amount due to trade creditors which, at 31 December



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HSBC HOLDINGS PLC

## Report of the Directors: Governance (continued)

### Corporate sustainability / Dividends, shareholders and meetings

2007, represented 22 days of average daily purchases of goods and services received from such creditors, calculated in accordance with the Companies Act 1985, as amended by Statutory Instrument 1997/571.

#### Donations

During the year, HSBC made charitable donations totalling US\$101 million (2006: US\$86.3 million). Of this amount, US\$36.8 million (2006: US\$32.8 million) was given for charitable purposes in the UK. No political donations were made during the year.

At the Annual General Meeting in 2007, shareholders renewed the authorities for HSBC Holdings and HSBC Bank to make EU political donations and incur EU political expenditure up to a maximum aggregate sum of £250,000 and £50,000 respectively as a precautionary measure in light of the wide definitions in The Political Parties, Elections and Referendums Act 2000. These authorities have not been used and will expire on the conclusion of the Annual General Meeting to be held in 2008.

#### Sustainability reporting

HSBC reports on its progress towards meeting the Group's environmental reduction targets and provides information for stakeholders in the annual *HSBC Sustainability Report* (previously called the *Corporate Responsibility Report*). The contents of the report are informed by feedback from stakeholder engagement forums, and are prepared using the Global Reporting Initiative guidelines. The report is verified by an external assurance provider to demonstrate to stakeholders that the information disclosed in the report is complete and covers material aspects of HSBC's business. The *HSBC Sustainability Report 2007* will be available at [www.hsbc.com/sustainabilityreport](http://www.hsbc.com/sustainabilityreport) from June 2008.

## Dividends, shareholders and meetings

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### Dividends for 2007

First, second and third interim dividends for 2007, each of US\$0.17 per ordinary share, were paid on 5 July 2007, 4 October 2007 and 16 January 2008 respectively. Note 12 on the Financial Statements gives more information on the dividends declared in 2007. On 3 March 2008, the Directors declared a fourth interim dividend for 2007 of US\$0.39 per ordinary share in lieu of a final dividend, which will be payable on 7 May 2008 in cash in US dollars, or in sterling or Hong Kong dollars at exchange rates to be determined on 28 April 2008, with a scrip dividend alternative. As the fourth interim dividend

for 2007 was declared after the balance sheet date it has not been included as a creditor at 31 December 2007. The reserves available for distribution at 31 December 2007 are US\$15,551 million.

A quarterly dividend of US\$15.50 per 6.20 per cent non-cumulative US dollar preference share, Series A (Series A dollar preference share), equivalent to a dividend of US\$0.3875 per Series A American Depositary Share, each of which represents one-fortieth of a Series A dollar preference share, was paid on 15 March, 15 June, 17 September and 17 December 2007.

### Dividends for 2008

The proposed timetable for interim dividends in respect of 2008 on the ordinary shares of US\$0.50 is set out in the Shareholder Information section on page 454.

A quarterly dividend of US\$15.50 per Series A dollar preference share (equivalent to a dividend of US\$0.3875 per Series A American Depositary Share, each of which represents one -fortieth of a Series A dollar preference share) was declared on 13 February 2008 for payment on 17 March 2008.

#### Communication with shareholders

Communication with shareholders is given high priority. Extensive information about HSBC's activities is provided in the *Annual Report and Accounts*, *Annual Review* and the *Interim Report* which are sent to shareholders and are available on [www.hsbc.com](http://www.hsbc.com). There is regular dialogue with institutional investors and enquiries from individuals on matters relating to their shareholdings and the business of HSBC are welcomed and are dealt with in an informative and timely manner. All shareholders are encouraged to attend the Annual General Meeting or the informal meeting of shareholders held in Hong Kong to discuss the progress of HSBC.

#### Notifiable interests in share capital

As at 3 March 2008, the following disclosures of major holdings of voting rights have been made to the Company pursuant to the requirements of the Financial Services Authority Disclosure and Transparency Rule 5:

- Singularis Holdings Limited; AWAL Trust Company Limited; and Maan Abdulwahed Al-Sanea gave notice on 16 April 2007 that it had an indirect interest on 16 April 2007 in 360,055,575 HSBC Holdings ordinary shares, representing 3.11 per cent of the ordinary shares

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in issue at that date.

- Barclays PLC gave notice on 17 April 2007 that it had an indirect interest on 16 April 2007 in 518,233,657 HSBC Holdings ordinary shares, representing 4.47 per cent of the ordinary shares in issue at that date.
- Legal & General Group Plc gave notice on 14 August 2007 that it had a direct interest on 8 August 2007 in 480,363,459 HSBC Holdings ordinary shares, representing 4.08 per cent of the ordinary shares in issue at that date.

There are no notifiable interests in the equity share capital recorded in the register maintained under section 336 of the Securities and Futures Ordinance of Hong Kong.

In compliance with the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited at least 25 per cent of the total issued share capital of HSBC Holdings has been held by the public at all times during 2007 and up to the date of this Report.

### **Dealings in HSBC Holdings shares**

Except for dealings as intermediaries by HSBC Bank, HSBC Financial Products (France) and The Hongkong and Shanghai Banking Corporation, which are members of a European Economic Area exchange, neither HSBC Holdings nor any subsidiary has bought, sold or redeemed any securities of HSBC Holdings during the year ended 31 December 2007.

### **Annual General Meeting**

The Annual General Meeting of HSBC Holdings will be held at the Barbican Hall, Barbican Centre, London EC2 on 30 May 2008 at 11.00am.

An informal meeting of shareholders will be held at Level 28, 1 Queen's Road Central, Hong Kong on Tuesday 27 May 2008 at 4.30pm.

Resolutions to receive the *Annual Report and Accounts*, approve the Directors' Remuneration Report, re-elect Directors and reappoint KPMG Audit Plc as Auditor will be submitted to the Annual General Meeting. KPMG Audit Plc has expressed its willingness to continue in office and the Group Audit Committee and the Board have recommended that KPMG Audit Plc be reappointed. Resolutions will also be submitted to the Annual General Meeting to renew the authorities for the allotment of shares, the disapplication of pre-emption rights and the purchase of ordinary shares. In addition, resolutions will be proposed to amend The HSBC Share Plan and to seek approval for changes to the Articles of Association.

A live webcast of the Annual General Meeting will be available on [www.hsbc.com](http://www.hsbc.com). From shortly after the conclusion of the Meeting until 30 June 2008 a recording of the proceedings will be available on [www.hsbc.com](http://www.hsbc.com).

On behalf of the Board  
S K Green, *Group Chairman*

3 March 2008

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HSBC HOLDINGS PLC

**Directors  Remuneration Report**[Remuneration committee / Principles / Executive Directors > Remuneration from 2008](#)

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**Remuneration Committee**

The Remuneration Committee meets regularly to consider human resource issues, particularly terms and conditions of employment, remuneration and retirement benefits. Within the authority delegated by the Board, the Committee is responsible for approving the remuneration policy of HSBC including the terms of bonus plans, share plans and other long-term incentive plans and for agreeing the individual remuneration packages of executive Directors and other senior Group employees. No Directors are involved in deciding their own remuneration.

Following each meeting the Committee reports to the Board on its activities. The terms of reference of the Committee are available at [www.hsbc.com/boardcommittees](http://www.hsbc.com/boardcommittees).

The members of the Remuneration Committee throughout 2007 were Sir Mark Moody-Stuart (Chairman) and J D Coombe. At the conclusion of the Annual General Meeting on 25 May 2007 W K L Fung and S Hintze retired as members of the Committee and G Morgan became a member of the Committee.

There were eight meetings of the Remuneration Committee during 2007. The table on page 296 gives details of Directors  attendance at these meetings.

In July 2007, following a competitive tender process, Mercer Limited, a firm of specialist human resources consultants, was appointed by the

Committee to provide independent advice on executive remuneration issues. As a global firm, Mercer also provides other remuneration consulting services to various parts of HSBC. Towers Perrin continues to provide remuneration data to the Remuneration Committee. Other consultants are used from time to time to advise on specific issues. During the year the Group Chief Executive provided regular briefings to the Remuneration Committee. The Committee received advice from the Group General Manager, Human Resources, being P Boyles

until June 2007 and thereafter A Almeida, and the Head of Group Performance and Reward, J Beadle.

## Overall principles

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In carrying out its responsibilities, the Remuneration Committee applies the following key principles:

- to ensure that the total remuneration package (salary, bonus, long-term incentive awards and other benefits) is competitive in relation to comparable organisations in each of the markets in which HSBC operates;
- to offer fair and realistic salaries with a focus on variable pay, differentiated by performance;
- through awards of shares to recognise high performance, retain key talent and provide alignment with the interests of shareholders; and
- to follow a policy of moving progressively from defined benefit to defined contribution pension schemes.

The Committee also considers corporate performance on environmental, social and governance factors when determining the executive Directors' remuneration. In addition, the Remuneration Committee has oversight that the incentive structure for senior management does not raise environmental, social and governance risks by inadvertently motivating irresponsible behaviour.

## Executive Directors

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Proposed changes to remuneration arrangements from 2008

In July 2007, the Remuneration Committee requested that Mercer conduct a comprehensive assessment of the remuneration arrangements of the executive Directors and other senior executives. The objective was to ensure close alignment with HSBC's business strategy, taking into account competitive market practice.

As part of this review, the Committee updated the remuneration comparator group to reflect more accurately the market in which the Company

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competes for executive talent. This group will comprise nine global financial services companies, namely Banco Santander, Bank of America, Barclays, BNP Paribas, Citigroup, Deutsche Bank, Royal Bank of Scotland, Standard Chartered and UBS. These companies were selected on the basis of their broadly similar business coverage, size and international scope.

While in general HSBC salaries for executive Directors were in the upper quartile of this comparator group, total cash (base salary and bonus) and total compensation (base salary, cash bonus and the expected value of long-term incentive awards) were generally at the lower quartile.

The Committee concluded that while the overall remuneration principles described above remain appropriate, the remuneration strategy should be refined by targeting base salary at the market median of the comparator group, while providing an opportunity for top quartile total compensation for higher levels of performance. At the same time, a greater proportion of total compensation will be share based, and shareholding requirements will be increased.

In order to achieve this, the following steps are proposed:

- For the executive Directors in place at the end of 2007, where base salaries are above market median no increases are being made in 2008. This applies to the Group Chairman, Group Chief Executive and Group Finance Director;
- The maximum annual bonus opportunity will be increased from 250 to 400 per cent of salary for the Group Chief Executive and Group Finance Director, with the criteria for bonus awards being made more specific and 40 per cent of any award being deferred into HSBC Restricted Shares;
- The performance measures and vesting conditions attached to long-term incentive awards of Performance Shares under The HSBC Share Plan will be amended in order to further align the reward of senior executives to the achievement of HSBC's strategy and the interests of its shareholders; and
- The required shareholding of senior executives under the share ownership guidelines will be increased to the equivalent of four to five times base salary to demonstrate further alignment with shareholders. This proposed policy would generally apply to all executive Directors from 2008 onwards. Under

the proposed arrangements, the performance-related proportion of the remuneration package will increase with the performance-related elements making up around 80 per cent of the remuneration package. Under the current arrangements, the performance-related proportion of the remuneration package is typically around 70 per cent of total compensation.

The arrangements for S T Gulliver, who has been appointed a Director with effect from 1 May 2008, will reflect the market practice in the Global Banking and Markets sector where a greater performance-related element is typical.

The net effect of these changes would mean, for example, that the Group Chief Executive's total compensation, on an expected value basis, would be at market median of the comparator group, but with a significantly higher proportion of share-based compensation than the group.

As part of the Company's on-going commitment to shareholder engagement, the largest institutional shareholders, representing approximately 50 per cent of the share capital of HSBC Holdings, the Association of British Insurers and the National Association of Pension Funds, are being consulted on these proposals. The planned implementation of these changes will be as follows:

#### Salary

As stated above, in 2008, in view of the current competitive positioning of base salaries, the Remuneration Committee will not increase base salaries for the executive Directors in place at the end of 2007.

The base salaries for executive Directors appointed to the Board after the 2007 financial year will be set in light of the overall remuneration principles set out above.

Any future salary increases will be considered in the light of the remuneration strategy, which targets base salary at market median, and the market data from the remuneration comparator group.

A similar approach has been adopted for other senior executives across the Group.

#### Annual bonus

From the 2008 performance year, objectives will be set and assessed using a [ ]balanced scorecard[ ]. This will include financial and non-financial performance measures, with an emphasis on tangible, measurable targets to ensure the appropriate alignment with HSBC[ ]s strategy in the assessment of annual bonus

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HSBC HOLDINGS PLC

**Directors** Remuneration Report (continued)*Executive Directors > Current arrangements / Performance conditions*

awards. Example measures for the Group Chief Executive are set out below:

**Financial**

- EPS
- ROE
- Cost efficiency ratio

**Customer**

- Customer recommendation
- Brand health

**Process**

- Operational losses
- Regulatory relationship

**People**

- Employee engagement
- Leadership

The Committee intends to provide significantly greater transparency in subsequent Reports regarding both the performance measures and the achievement against performance targets, together with a commentary on the resulting levels of bonus awards.

## Long-term incentive plan

The long-term incentive plan (LTIP) was last reviewed in 2005 when, with the adoption of The HSBC Share Plan, a growth in earnings per share measure (EPS) was introduced alongside Total Shareholder Return (TSR) relative to a peer group of 28 banks.

The Committee is proposing changes to the performance measures and vesting conditions of the long-term incentive awards of Performance Shares under The HSBC Share Plan, the details of which will be described in the circular containing the Notice of the 2008 Annual General Meeting, which is expected to be sent to shareholders in April 2008, and submitted to shareholder vote at that Meeting.

Awards will be granted to executive Directors and other senior executives shortly after the Meeting. These will be made under the amended Plan subject to the proposed changes to the Plan receiving shareholder approval.

## Current arrangements

## Salary

The Committee reviews salary levels for executive Directors each year.

As described above, the Remuneration Committee will not increase base salaries for current executive Directors in 2008.

	<b>2008</b>	2007
	<b>£000</b>	£000
D J Flint	<b>700</b>	700
M F Geoghegan	<b>1,070</b>	1,070
S K Green	<b>1,250</b>	1,250
Annual cash bonus		

The annual cash bonus for executive Directors is based upon individual performance as well as performance measured against a number of key financial targets for the Group, including financial (e.g. revenue growth,



economic profit and cost efficiency). Annual bonus payments are not pensionable.

The Committee took into account the Group's absolute performance and relative performance compared to its peers in a challenging operating environment, in setting the overall bonus payment levels.

There were significant increases in profit before tax, earnings per share and improvements in cost efficiencies during 2007. During that year management moved effectively to resolve the issues identified in late 2006 in the United States in relation to consumer lending, and to anticipate and respond to the sector-wide liquidity crisis.

On this basis, the Remuneration Committee approved annual bonus payments for the following executive Directors in 2008 in respect of 2007 performance (payments made in 2007 in respect of 2006 performance are shown for reference):

	<b>2008</b> <b>£000</b>	2007 £000
D J Flint	<b>800</b>	500
M F Geoghegan	<b>2,140</b>	1,750
Chairman's variable compensation		

The Committee has determined, at the request of the Chairman, that future variable compensation payments to the Chairman will be delivered exclusively through Performance Share awards given the key focus of the role of the Chairman in the formation and management of Group strategy.

The Remuneration Committee approved an annual bonus payment for the Chairman for 2008, in respect of 2007 performance, that was unchanged from the prior performance year as indicated in the table below (the payment made in 2007 in respect of 2006 performance is shown for reference):

	<b>2008</b> <b>£000</b>	2007 £000
S K Green	<b>1,750</b>	1,750
Long-term incentive plan		

Under The HSBC Share Plan, executive Directors, as with other participants in the Plan, are eligible to receive awards of Performance Shares with a face value at grant of up to a maximum of seven times

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salary. The individual awards received in any one year are based on market competitive information and individual performance. The face and expected

values of individual awards made in 2007 are set out in the table below (awards made in 2006 are shown for reference).

## 2007 awards

	Face value		Expected value <sup>1</sup>	
	2007 £000	2006 £000	2007 £000	2006 £000
D J Flint	2,200	1,600	968	704
M F Geoghegan <sup>2</sup>	5,000	2,000	2,200	880
S K Green <sup>3</sup>	3,750	2,500	1,650	1,100
<b>Total</b>	<b>10,950</b>	<b>6,100</b>	<b>4,818</b>	<b>2,684</b>

1 44 per cent of the face value.

2 M F Geoghegan's 2006 award relates to his position as Chief Executive of HSBC Bank plc, prior to his current role as Group Chief Executive of HSBC Holdings.

3 S K Green's 2006 award relates to his position as Group Chief Executive.

Vesting of the awards is subject to the performance conditions described in the next section being met. Shares released will include additional shares equivalent to the value of the dividends payable on the vested shares over the performance period.

## Performance conditions

### Arrangements from 2005 to 2007

Vesting of the awards of Performance Shares under The HSBC Share Plan is based on two independent measures, relative TSR and growth in EPS. The performance conditions are measured over a three-year performance period and awards forfeited to the extent that they have not been met. The vesting of 50 per cent of the awards is based on TSR and the remaining 50 per cent on growth in EPS.

### TSR award

The comparator group of 28 banks for the TSR award comprises the largest banks in the world, on the basis of their market capitalisation, their geographic spread and the nature of their activities:

ABN AMRO	Mitsubishi Tokyo Financial Group
Banco Santander	Mizuho Financial Group
Bank of America	Morgan Stanley
Bank of New York	National Australia Bank
Barclays	Royal Bank of Canada
BBVA	Royal Bank of Scotland
BNP Paribas	Société Générale
Citigroup	Standard Chartered
Crédit Agricole	UBS

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Credit Suisse Group	UniCredito Italiano
Deutsche Bank	US Bancorp
HBOS	Wachovia
JP Morgan Chase	Wells Fargo
Lloyds TSB	Westpac Banking Corporation

The extent to which the TSR award will vest will be determined on a sliding scale based on

HSBC's relative TSR ranking, measured over the three years, against the comparator group as shown below:

If HSBC's performance matches	Proportion of TSR Award vesting <sup>1</sup>
Banks ranking 1 <sup>st</sup> to 7 <sup>th</sup>	100%
Bank ranking 8 <sup>th</sup>	90%
Bank ranking 9 <sup>th</sup>	80%
Bank ranking 10 <sup>th</sup>	70%
Bank ranking 11 <sup>th</sup>	60%
Bank ranking 12 <sup>th</sup>	50%
Bank ranking 13 <sup>th</sup>	40%
Bank ranking 14 <sup>th</sup>	30%
Banks ranking below 14 <sup>th</sup>	nil

<sup>1</sup> Vesting will occur in a straight line where HSBC's performance falls between these incremental steps.

**EPS award**

The method for calculating EPS growth has been summarised in narrative form in the 2005 and 2006 Directors' Remuneration Reports, as well as in the circular containing the Notice of Annual General Meeting for 2005.

This year's Report sets out more information (including a graph and an example) on the method of calculation of EPS growth in light of some questions from shareholders on the operation of this element. The Committee regrets if there has been any misunderstanding, but wishes to reassure shareholders that the method of calculation, which is set out in the rules of The HSBC Share Plan, has remained unchanged since the Plan was adopted. Further, before introducing the Plan in 2005, the Committee consulted extensively with major shareholders and their representative bodies in line with best practice, and the rules of the Plan including worked examples of the EPS calculation were available for inspection at the time.

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HSBC HOLDINGS PLC

**Directors' Remuneration Report** (continued)*Executive Directors > Performance conditions / TSR*

The percentage of the conditional award vesting will depend upon the absolute growth in EPS achieved over the three years (the performance period). 30 per cent of the conditional shares will vest if the incremental EPS over the performance period is 24 per cent or more of EPS in the base year. The percentage of shares vesting will rise on a straight line proportionate basis to 100 per cent if HSBC's incremental EPS over the performance period is 52 per cent or more of EPS in the base year. In the interests of clarity, this has been set out in graphical form in the chart below.

For the EPS element of the award, the base measure shall be EPS for the financial year preceding that in which the award is made (the base year). Absolute growth in EPS will then be compared with the base year over three consecutive financial years commencing with the year in which the award is made. Incremental EPS will be calculated by expressing as a percentage of the EPS of the base year the difference each year of the three-year performance period between the EPS of that year and the EPS of the base year. These percentages will then be aggregated to arrive at the total incremental EPS for the performance period. As illustrated in the table below, an incremental EPS of 51 per cent over three years would equate to a compound annual growth rate of 8 per cent.

Percentage difference between:				Total
Year 1 EPS and Base Year	Year 2 EPS and Base Year	Year 3 EPS and Base year		incremental EPS for the performance period
EPS	+	EPS	+	EPS
8%		17%		51%

*Illustration of incremental EPS of 51 per cent over three years.*

If EPS in any of the Years 1, 2 or 3 is below the base year, then the percentage difference between that particular year and the base year is negative.

For this purpose, EPS means the profit attributable to the Shareholders (expressed in US dollars), excluding goodwill amortisation, divided by the weighted average number of Ordinary Shares in issue and held outside the Group during

the year in question. In the event that the published EPS for the base year is restated during the performance period to adjust for changes in accounting standards, that restated EPS will be used for the purposes of the EPS performance condition.

In addition, awards will not vest unless the Remuneration Committee is satisfied that HSBC Holdings' financial performance has shown a sustained improvement in the period since the award date. In determining whether HSBC Holdings has achieved a sustained improvement in performance the Remuneration Committee will take account of all relevant factors but in particular comparisons against the comparator group in areas such as revenue growth and mix, cost efficiency, credit performance, cash return on cash invested, dividend performance and TSR.

If events occur which cause the Remuneration Committee to consider that a performance condition has become unfair or impractical in either direction, the right is reserved to the Remuneration Committee, if it considers it appropriate to do so, to amend, relax or waive the condition.

Awards will vest in full immediately in cases of death. In the event of redundancy, retirement on grounds of injury or ill health, early retirement by agreement, normal retirement and where a participant ceases to be

employed by HSBC due to a company ceasing to be part of HSBC, awards will normally vest at the end of the vesting period on a time-apportioned basis to the extent that the TSR and EPS performance conditions have been satisfied. In the event of a change of control, awards will normally vest immediately and on a time-apportioned basis to the extent that the TSR performance condition has been satisfied. Awards will normally be forfeited if the participant is dismissed for cause or resigns from HSBC. In all these circumstances the Committee retains discretion to ensure fair and reasonable treatment.

#### Arrangements from 2002 to 2004

Between 2002 and 2004, awards of Performance Shares were made under the HSBC Holdings Restricted Share Plan 2000. Vesting was based on HSBC's relative TSR performance over a three-year period from the date of the award, with full vesting of awards and transfer of shares to participants being no earlier than the fifth anniversary of the date of award.

The initial performance period was three years from the date of award. Prior to 2004, awards were subject to re-testing on the fourth

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and fifth anniversaries of the date of award if the performance target was not met at the third anniversary. The awards made in 2004 had a three-year performance period with no re-testing.

The table below describes the outcome of the performance tests for the 2002, 2003 and 2004 awards:

	<u>2002 award</u>	<u>2003 award</u>	<u>2004 award</u>
First test (third anniversary)	March 2005, performance target met, awards vested in 2007	March 2006, performance target not met	March 2007, performance target not met, and therefore award forfeited
First re-test (fourth anniversary)	Already vested	March 2007, performance target not met	No re-test
Second test (fifth anniversary)	Already vested	March 2008	No re-test

In addition to these performance conditions, none of the outstanding awards will vest unless the Remuneration Committee is satisfied that, during the performance period, HSBC Holdings has achieved sustained growth. The Remuneration Committee retains discretion to recommend early release of shares awarded in certain circumstances, for example, retirement, redundancy or ill health. When events occur which cause the Remuneration Committee to consider that the performance conditions have become unfair or impractical, the right is reserved for the Committee to amend or substitute the performance conditions.

#### Funding

The Company's policy is to fund long-term incentive awards of Performance Shares and Restricted Shares under The HSBC Share Plan through employee benefit trusts which undertake market purchases of HSBC Holdings' shares. The dilution limits set out in the HSBC share plans comply with the Association of British Insurers' guidelines.

#### Total Shareholder Return

The graphs below show how HSBC has performed against the benchmark TSR used to determine vesting for the 2004 Performance Share awards and the FTSE 100 Index.

#### **Graph 1: HSBC TSR and Benchmark TSR**

#### **Graph 2: HSBC TSR and FTSE 100 Index**

Pursuant to the Directors' Remuneration Report Regulations 2002, Graph 2 shows HSBC's TSR performance against the FTSE 100 Index, for the five-year period ended 31 December 2007. The FTSE 100 has been chosen as this is a recognised broad equity market index of which HSBC Holdings is a member.

#### Pensions

The normal retirement age for executive Directors is 65. The pension entitlements earned by the executive Directors during the year are set out on page 330.

Share ownership guidelines

In line with a focus on highly leveraged variable pay, HSBC operates a formal share ownership policy, expressed as a number of shares, for the executive Directors and the Group Managing Directors. The Committee believes that material levels of share ownership by executives create a community of interest between the leadership team and shareholder. The executive Directors and Group Managing Directors are therefore required to build and retain the following shareholdings:

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HSBC HOLDINGS PLC

**Directors' Remuneration Report** (continued)*Executive Directors / Non-executive Directors / Directors emoluments*

	<b>Number of shares</b>	
	<b>to be held</b>	<b>at 31 December 2007</b>
Group Chairman	300,000	<b>536,652</b>
Group Chief Executive	300,000	<b>385,189</b>
Group Finance Director	100,000	<b>112,781</b>
Group Managing Directors	75,000	1

1 A majority of the Group Managing Directors exceed the expected holdings; where the holdings are below, the executives are within five years of their appointment and working towards the expected level.

Under the guidelines, the shareholding is expected to be achieved within five years of the executive's appointment or three years from the date of approval of the guidelines (May 2007), whichever is the later. All executive Directors and the majority of Group Managing Directors exceed the required shareholding. The Remuneration Committee will monitor compliance annually prior to approving any awards or vesting of Performance Shares. The Remuneration Committee will have full discretion in determining any penalties in case of non-compliance, which could include: a reduction of future awards of long-term incentives and/or an increase in the proportion of the annual bonus that is deferred into shares. Increases in the expected level of share ownership will be introduced as part of the refinements to reward strategy and structure from 2008 discussed above.

**Service contracts**

HSBC's policy is to employ executive Directors on one-year rolling contracts although longer initial terms may be approved by the Remuneration Committee if considered appropriate. The Remuneration Committee will, consistent with the best interests of the Group, seek to minimise termination payments.

S K Green, M F Geoghegan and D J Flint have rolling service contracts with a notice period of 12 months for either party save that D J Flint's contract provides for nine months' notice to be given by Mr Flint.

In the event of early termination of employment of S K Green, M F Geoghegan, or D J Flint, other than for cause, HSBC is entitled to make a payment in lieu of notice equal in the case of D J Flint, to base salary and pension entitlement and in the case of S K Green and M F Geoghegan to base salary, pension entitlements and other benefits.

In addition, on termination of employment by HSBC, other than for cause (or termination by either party within 12 months following a change of control), S K Green and M F Geoghegan will be eligible for a bonus calculated as not less than the

average of the previous two years of bonus payments received, pro-rated for any part year worked to termination.

The dates of executive Directors' service contracts are as follows:

	<b>Contract date</b>
D J Flint	29 September 1995



M F Geoghegan	24 May 2007
S K Green	24 May 2007
Other directorships	

Executive Directors, if so authorised by either the Nomination Committee or the Board, may accept appointments as non-executive directors of suitable companies which are not part of HSBC. Approval will not be given for executive Directors to accept a non-executive directorship of more than one FTSE 100 company. When considering a non-executive appointment, the Nomination Committee or Board will take into account the expected time commitment of such appointment. The time commitment for executive Directors' external appointments will be reviewed as part of the annual Board review. Any remuneration receivable in respect of an external appointment is normally paid to HSBC, unless otherwise approved by the Remuneration Committee. D J Flint does not retain his fees as a non-executive Director of BP p.l.c.

## **Non-executive Directors**

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Non-executive Directors are appointed for fixed terms not exceeding three years, subject to their re-election by shareholders at Annual General Meetings. Non-executive directors have no service contract and are not eligible to participate in HSBC's share plans. Current non-executive Directors' terms of appointment will expire as follows: in 2008, Lord Butler, Baroness Dunn and Sir Brian Moffat; in 2009, W K L Fung, S W Newton, S M Robertson and Sir Brian Williamson; in 2010, R A Fairhead, Sir Mark Moody-Stuart and G Morgan; and in 2011, J D Coombe, J L Dúran, J W J Hughes-Hallett and W S H Laidlaw. S A Catz and N R N Murthy were appointed non-executive Directors with effect from 1 May 2008. Subject to their re-election by shareholders at the Annual General Meeting in 2008, their terms of appointment will expire in 2011.

### **Fees**

Non-executive Directors' fees are regularly reviewed and compared with other large international companies. The current fee, which was approved by shareholders in 2006, is £65,000 per annum.

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A fee of £30,000 per annum is payable to the senior independent non-executive Director. In addition, non-executive Directors receive the following fees for service on Board Committees:

Chairman, Audit Committee	£50,000 p.a.
Member, Audit Committee	£20,000 p.a.

*During 2007, seven meetings of the Group Audit Committee were held.*

Chairman, Remuneration Committee	£40,000 p.a.
Member, Remuneration Committee	£20,000 p.a.

*During 2007, eight meetings of the Remuneration Committee were held.*

Chairman, Nomination Committee	£30,000 p.a.
Member, Nomination Committee	£20,000 p.a.

*During 2007, two meetings of the Nomination Committee were held.*

Chairman, Corporate Sustainability Committee	£30,000 p.a.
Member, Corporate Sustainability Committee	£20,000 p.a.

*During 2007, five meetings of the Corporate Sustainability Committee were held.*

## Directors' emoluments

The emoluments of the Directors of HSBC Holdings for 2007 were as follows:

	<b>Fees £000</b>	<b>Salary £000</b>	<b>Allowance<sup>1</sup> £000</b>	<b>Benefits in kind<sup>2</sup> £000</b>	<b>Bonuses<sup>3</sup> £000</b>	<b>Total 2007 £000</b>	<b>Total 2006 £000</b>
<b>Executive Directors</b>							
D J Flint	□	679	374	25	800	1,878	1,355
M F Geoghegan <sup>4</sup>	□	1,040	520	61	1,915	3,536	2,868
S K Green	□	1,250	□	12	1,750	3,012	2,934
<b>Non-executive Directors</b>							
Lord Butler	103	□	□	□	□	103	115
R K F Chieffo <sup>6</sup>	79	□	□	□	□	79	200
J D Coombe	105	□	□	□	□	105	97
Baroness Dunn	85	□	□	□	□	85	85
R A Fairhead	103	□	□	□	□	103	85
W K L Fung <sup>7</sup>	122	□	□	□	□	122	136
J F Gil Díaz <sup>8</sup>	□	□	□	□	□	□	□
S Hintze <sup>5</sup>	44	□	□	□	□	44	105
J W J Hughes-Hallett	97	□	□	□	□	97	77
Sir Brian Moffat	110	□	□	□	□	110	145
Sir Mark Moody-Stuart	125	□	□	□	□	125	125
G Morgan	77	□	□	□	□	77	16
S W Newton	77	□	□	□	□	77	65
S M Robertson	94	□	□	□	□	94	65
H Sohmen <sup>5, 9</sup>	□	□	□	□	□	□	□
Sir Brian Williamson	91	□	□	□	□	91	85

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Total <sup>10</sup>	<b>1,312</b>	<b>2,969</b>	<b>894</b>	<b>98</b>	<b>4,465</b>	<b>9,738</b>	11,485
Total (US\$000) <sup>10</sup>	<b>2,626</b>	<b>5,943</b>	<b>1,790</b>	<b>196</b>	<b>8,938</b>	<b>19,493</b>	21,139

- 1 *Executive allowance paid to fund personal pension arrangements.*
- 2 *Benefits in kind for executive Directors include provision of company car, medical insurance, other insurance cover, accountancy advice and travel assistance.*
- 3 *These discretionary bonuses are in respect of 2007. See page 324 for comparison with 2006.*
- 4 *In return for the prior waiver of part of his bonus, an employer contribution has been made into a pension arrangement for M F Geoghegan equal to £225,000 (2006: £215,000) which would otherwise have been paid.*
- 5 *Retired as a Director on 25 May 2007.*
- 6 *Includes fees as non-executive Chairman of HSBC Private Equity (Asia) Limited and as a non-executive Director of The Hongkong and Shanghai Banking Corporation.*
- 7 *Includes fees as a non-executive Director of The Hongkong and Shanghai Banking Corporation.*
- 8 *Appointed as a Director on 2 January 2007 and retired as a Director on 5 March 2007. J F Gil Díaz elected to waive any fees payable to him by HSBC Holdings (£10,833).*
- 9 *H Sohmen elected to waive any fees payable to him by HSBC Holdings (2007: £27,083; 2006: £65,000).*
- 10 *Total emoluments for 2006 include the emoluments of Directors who retired in that year.*

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HSBC HOLDINGS PLC

**Directors' Remuneration Report**(continued)*Pensions / Share plans***Pensions**

S K Green is entitled to receive benefits from an Employer-Funded Retirement Benefits Scheme (EFRBS). The benefits to which he is entitled from the HSBC Bank (UK) Pension Scheme but in respect of which he ceased membership on 5 April 2006, will be calculated based on completed service to the date of opting out and on pensionable salary calculated at the date employment with HSBC Holdings ceases. The intention of this arrangement is to provide benefits to Mr Green that would be broadly comparable to an accrual rate of one-

thirtieth of pensionable salary for each year of pensionable service.

For M F Geoghegan an employer contribution was made to the HSBC Asia Holdings Pension Plan in respect of 2007 of £225,000 (2006: £215,000) arising entirely from a bonus sacrifice. There were no other employer contributions made to this plan. Mr Geoghegan receives an executive allowance of 50 per cent of annual basic salary to fund personal pension arrangements.

D J Flint receives an executive allowance of 55 per cent of annual basic salary to fund personal pension arrangements.

			Increase in accrued pension during 2007, excluding any increase for inflation £000	Transfer value of accrued pension at 31 December 2006 <sub>1</sub> £000	Transfer value of accrued pension at 31 December 2007 <sub>1</sub> £000	Increase of transfer value of accrued pension (less personal contributions) in 2007 <sub>1</sub> £000	Transfer value (less personal contributions) at 31 December 2007 relating to increase in accrued pensions during 2007, excluding any increase for inflation <sub>1</sub> £000
Accrued annual pension at 31 December 2007 £000	Increase in accrued pension during 2007 £000						
S K Green	628	42	19	11,082	12,780	1,698	383

1 The transfer value represents a liability of HSBC's pension funds and not a sum paid or due to the individual; it cannot therefore meaningfully be added to annual remuneration.

The following unfunded pension payments, in respect of which provision has been made, were made during 2007 to five former Directors of HSBC Holdings:

	2007 £	2006 £
B H Asher	<b>93,812</b>	90,465
C F W de Croisset	<b>194,077</b>	178,344
R Delbridge	<b>134,934</b>	130,120
Sir Brian Pearse	<b>56,269</b>	54,261
Sir William Purves	<b>99,310</b>	95,767
	<b>578,402</b>	548,957

The payments in respect of R Delbridge and Sir Brian Pearse were made by HSBC Bank plc as former Directors of that bank. The payment in respect of C F W de Croisset was made by HSBC France as a former Director of that bank.

## Share plans

At 31 December 2007, the undernamed Directors held Performance Share awards and options to acquire the number of HSBC Holdings ordinary shares set against their respective names.

The options under the HSBC Holdings Savings-Related Share Option Plan were awarded for nil consideration and are exercisable at a 20 per cent discount to the average market value of the ordinary shares on the five business days immediately preceding the invitation date. Under the Securities and Futures Ordinance of Hong Kong the options are categorised as [unlisted physically settled equity derivatives]. No options lapsed during the year and except as otherwise indicated, no options were awarded or exercised during the year. There are no performance criteria conditional upon which the outstanding options are exercisable.

The market value of the ordinary shares at 31 December 2007 was £8.42. The highest and lowest market values during the year were £9.64 and £8.03. Market value is the mid-market price derived from the London Stock Exchange Daily Official List on the relevant date.

Under the Securities and Futures Ordinance of Hong Kong, Performance Share awards under The HSBC Share Plan and the HSBC Holdings Restricted Share Plan 2000 are categorised as [the interests of a beneficiary of a Trust].

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HSBC Holdings Savings-Related Share Option Plan  
 HSBC Holdings ordinary shares of US\$0.50

	Date of award	Exercise price (£)	Exercisable from <sub>1</sub>	Exercisable until	Options at 1 January 2007	Options awarded during year	Options exercised during year	Options at 31 December 2007
D J Flint	2 May 2002	6.3224	1 Aug 2007	31 Jan 2008	2,617	□	2,617 <sub>2</sub>	□
	24 Apr 2007	7.0872	1 Aug 2012	31 Jan 2013	□	2,310	□	2,310
S K Green	23 Apr 2003	5.3496	1 Aug 2008	31 Jan 2009	3,070	□	□	3,070

1 *May be advanced to an earlier date in certain circumstances, e.g. retirement.*

2 *Options over 2,617 shares were exercised on 11 September 2007. At the date of exercise, the market value per share was £8.82.*

The HSBC Share Plan

HSBC Holdings ordinary shares of US\$0.50

	Date of award	Year in which awards may vest	Awards at 1 January 2007	Awards made during year <sub>1</sub>	Monetary value of awards made during year £000	Awards at 31 December 2007 <sub>2</sub>
D J Flint	27 May 2005	2008	185,821	□	□	194,796
	6 Mar 2006	2009	167,220	□	□	175,296
	5 Mar 2007	2010	□	246,185	2,200	256,029
M F Geoghegan	27 May 2005	2008	247,761	□	□	259,728
	6 Mar 2006	2009	209,025	□	□	219,121
	5 Mar 2007	2010	□	559,513	5,000	581,884
S K Green	27 May 2005	2008	309,701	□	□	324,659
	6 Mar 2006	2009	261,280	□	□	273,900
	5 Mar 2007	2010	□	419,635	3,750	436,413

*Vesting of these Performance Share awards is subject to the performance conditions described on page 325 being satisfied.*

*At the date of the award, 5 March 2007, the market value (closing price) per share was £8.96. The Trustee of*

1 *the Plan purchased the shares at a price of £8.936358.*

2 *Includes additional shares arising from scrip dividends.*

HSBC Holdings Restricted Share Plan 2000

HSBC Holdings ordinary shares of US\$0.50

Monetary

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	Date of award	Year in which awards may vest	Awards at 1 January 2007	Awards vested during year <sup>1</sup>	value of awards vested during year £000	Awards at 31 December 2007 <sup>1</sup>
D J Flint	8 Mar 2002	2007	90,176	90,897 <sub>2</sub>	830	□
	5 Mar 2003	2008	129,917	□	□	136,192
	4 Mar 2004	2009	136,357	□	□	□ <sup>3</sup>
M F Geoghegan	8 Mar 2002	2007	45,089	45,449 <sub>2</sub>	414	□
	5 Mar 2003	2008	60,630	□	□	63,558
	4 Mar 2004	2009	102,268	□	□	□ <sup>3</sup>
S K Green	8 Mar 2002	2007	112,720	113,621 <sub>2</sub>	1,036	□
	5 Mar 2003	2008	129,917	□	□	136,192
	4 Mar 2004	2009	187,490	□	□	□ <sup>3</sup>

*Vesting of these Performance Share awards is subject to the attainment of predetermined TSR targets over a three-year period from the date of the award. Full vesting and transfer of the shares will not generally occur until the fifth anniversary of the date of award. A benchmark for HSBC Holdings' TSR, weighted by market capitalisation, was established which takes account of the TSR performance of: (1) a peer group of nine banks weighted by market capitalisation which were considered most relevant to HSBC in terms of size and international scope. For performance periods up to and including the one beginning in 2003, this group comprised ABN AMRO Holding N.V., The Bank of East Asia, Limited, Citigroup Inc., Deutsche Bank AG, JPMorgan Chase & Co., Lloyds TSB Group plc, Mitsubishi Tokyo Financial Group Inc., Oversea-Chinese Banking Corporation Limited and Standard Chartered PLC. To be more relevant to HSBC in terms of size and international scope, this peer group was amended for conditional awards made in 2004 by the replacement of Lloyds TSB Group plc,*

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HSBC HOLDINGS PLC

**Directors' Remuneration Report**(continued)*Share plans / Statement of Directors' Responsibilities*

Oversea-Chinese Banking Corporation Ltd., Mitsubishi Tokyo Financial Group Inc. and The Bank of East Asia, Limited with Bank of America Corporation, The Royal Bank of Scotland Group plc, Banco Santander Central Hispano S.A. and UBS AG; (2) the five largest banks from each of the US, the UK, continental Europe and the Far East, other than any within (1) above, weighted by market capitalisation; and (3) the banking sector of the Morgan Stanley Capital International World Index, excluding any within (1) or (2) above, weighted by market capitalisation. By combining the weighted average TSR for each of the above three groups and weighting that average so that 50 per cent is applied to (1), 25 per cent is applied to (2) and 25 per cent is applied to (3), a single TSR benchmark for market comparison was determined. The benchmark was chosen to reward the delivery of sustained financial growth of HSBC Holdings and to align the interests of participants with those of shareholders. The extent to which each award will vest will be determined by reference to HSBC Holdings' TSR measured against the TSR benchmark. If HSBC Holdings' TSR over the performance period exceeds the benchmark TSR, awards with a value, at the date of grant, of up to 100 per cent of the individual's earnings (base salary and bonus in respect of the previous performance year), will vest. For higher value awards, the greater of 50 per cent of the award or the number of shares equating at the date of grant to 100 per cent of the individual's earnings, will vest at this level of performance. If HSBC Holdings' TSR over the performance period places it within the upper quartile of the ranked list of the banks comprising the benchmark, these higher value awards will vest in full. For performance between the median and the upper quartile, vesting will be on a straight-line basis. If the upper quartile performance level is achieved at the third anniversary of the date of award then an additional award equal to 20 per cent of the initial Performance Share award will be made and will vest at the same time as the original award to which it relates.

- 1 Includes additional shares arising from scrip dividends.
- 2 The performance conditions have been met and the shares have vested. At the date of vesting, 8 March 2007, the market value per share was £9.12. At the date of the award, 8 March 2002, the market value per share was £8.34.
- 3 The performance conditions for awards made in 2004 were not met and, under the rules of the Plan, the awards held by D J Flint (137,447 shares), M F Geoghegan (103,086 shares) and S K Green (188,990 shares) were forfeited on 4 April 2007.

On behalf of the Board

3 March 2008

Sir Mark Moody-Stuart, *Chairman of Remuneration Committee*



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HSBC HOLDINGS PLC

## **Statement of Directors' Responsibilities in respect of the Annual Report and Accounts 2007 and the Financial Statements**

The following statement, which should be read in conjunction with the Auditors' statement of their responsibilities set out in their report on pages 334 and 335, is made with a view to distinguishing for shareholders the respective responsibilities of the Directors and of the Auditors in relation to the financial statements.

The Directors are responsible for preparing the Annual Report, the consolidated financial statements of HSBC Holdings and its subsidiaries (the "Group") and holding company financial statements for HSBC Holdings (the "parent company") in accordance with applicable law and regulations.

Company law requires the Directors to prepare Group and parent company financial statements for each financial year. The Directors are required to prepare the Group financial statements in accordance with IFRSs as adopted by the EU and have elected to prepare the parent company financial statements on the same basis.

The Directors are also required to present additional information for US Shareholders. Accordingly these financial statements are framed to meet both UK and US requirements to give a consistent view to all shareholders.

The Group and parent company financial statements are required by law and IFRSs as adopted by the EU to present fairly the financial position of the Group and the parent company and the performance for that period; the Companies Act 1985 provides in relation to such financial statements that references in the relevant part of that Act to financial statements giving a true and fair view are references to their achieving a fair presentation. In addition, in order to meet certain US requirements, we are required to present our financial statements in accordance with IFRSs as adopted by the International Accounting Standards Board ("IASB"). Currently, there are no differences in application to HSBC between IFRS endorsed by the EU and IFRS issued by the IASB.

In preparing each of the Group and parent company financial statements, the Directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgments and estimates that are reasonable and prudent; and
- state whether they have been prepared in accordance with IFRSs as adopted by the EU.

The Directors are required to prepare the financial statements on the going concern basis unless it is not appropriate. Since the Directors are satisfied that the Group has the resources to continue in business for the foreseeable future, the financial statements continue to be prepared on the going concern basis.

The Directors have responsibility for ensuring that sufficient accounting records are kept that disclose with reasonable accuracy at any time the financial position of the parent company and enable them to ensure that its financial statements comply with the Companies Act 1985.

The Directors have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the Group and to prevent and detect fraud and other irregularities.

Under applicable law and regulations, the Directors also have responsibility for preparing a Directors' Report, Directors' Remuneration Report and the Corporate Governance statement on pages 289 to 332 that comply with that law and those regulations.

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The Directors have responsibility for the maintenance and integrity of the Annual Report and Accounts as they appear on the company's website. Legislation in the UK governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

On behalf of the Board  
R G Barber, *Secretary*

3 March 2008

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HSBC HOLDINGS PLC

**Report of Independent Registered Public Accounting Firm  
to the Board of Directors and shareholders of HSBC  
Holdings plc**

We have audited the accompanying consolidated financial statements of HSBC Holdings plc and its subsidiary undertakings (together HSBC) on pages 337 to 452 which comprise the consolidated balance sheets as of 31 December 2007 and 2006, and the related consolidated income statements, consolidated cash flow statements and consolidated statements of recognized income and expense, for each of the years in the three-year period ended 31 December 2007, including the disclosures marked "audited" within the critical accounting policies on pages 132 to 134, the "Report of the Directors: The Management of Risk" section on pages 192 to 288 and the "Off-balance sheet arrangements and special purpose entities" section on pages 183 to 191. We have also audited HSBC's internal control over financial reporting as of 31 December 2007, based on the framework for Directors' internal control evaluation contained within the Combined Code (The Revised Turnbull Guidance), and the criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). HSBC's management is responsible for these consolidated financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Assessment of Internal Controls. Our responsibility is to express an opinion on these consolidated financial statements and an opinion on the effectiveness of HSBC's internal control over financial reporting based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the consolidated financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on assessed risk. Our audits also included performing other such procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of HSBC as of 31 December 2007 and 2006, and the results of their operations and their cash flows for each of the years in the three-year period ended 31 December 2007, in conformity with International Financial Reporting Standards (IFRSs) as adopted by the European Union (EU) and IFRSs as issued by the International Accounting Standards Board (IASB). Also in our opinion, HSBC maintained, in all material

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respects, effective internal control over financial reporting as of 31 December 2007, based on the framework for Directors' internal control evaluation contained within the Combined Code (The Revised Turnbull Guidance) and the criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

KPMG Audit Plc  
London, England  
3 March 2008

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[Back to Contents](#)**Consolidated income statement for the year ended 31 December 2007**

	Notes	2007 US\$m	2006 US\$m	2005 US\$m
Interest income		92,359	75,879	60,094
Interest expense		(54,564)	(41,393)	(28,760)
Net interest income		37,795	34,486	31,334
Fee income		26,337	21,080	17,486
Fee expense		(4,335)	(3,898)	(3,030)
Net fee income		22,002	17,182	14,456
Trading income excluding net interest income		4,458	5,619	3,656
Net interest income on trading activities		5,376	2,603	2,208
Net trading income		9,834	8,222	5,864
Net income from financial instruments designated at fair value	3	4,083	657	1,034
Gains less losses from financial investments		1,956	969	692
Gains arising from dilution of interests in associates	4	1,092		
Dividend income		324	340	155
Net earned insurance premiums	5	9,076	5,668	5,436
Other operating income		1,439	2,546	2,733
<b>Total operating income</b>		<b>87,601</b>	<b>70,070</b>	<b>61,704</b>
Net insurance claims incurred and movement in liabilities to policyholders	6	(8,608)	(4,704)	(4,067)
<b>Net operating income before loan impairment charges and other credit risk provisions</b>		<b>78,993</b>	<b>65,366</b>	<b>57,637</b>
Loan impairment charges and other credit risk provisions		(17,242)	(10,573)	(7,801)
<b>Net operating income</b>	7	<b>61,751</b>	<b>54,793</b>	<b>49,836</b>
Employee compensation and benefits	8	(21,334)	(18,500)	(16,145)
General and administrative expenses	9	(15,294)	(12,823)	(11,183)
Depreciation and impairment of property, plant and equipment	23	(1,714)	(1,514)	(1,632)
Amortisation and impairment of intangible assets	22	(700)	(716)	(554)
<b>Total operating expenses</b>		<b>(39,042)</b>	<b>(33,553)</b>	<b>(29,514)</b>
<b>Operating profit</b>		<b>22,709</b>	<b>21,240</b>	<b>20,322</b>
Share of profit in associates and joint ventures	21	1,503	846	644
<b>Profit before tax</b>		<b>24,212</b>	<b>22,086</b>	<b>20,966</b>
Tax expense	11	(3,757)	(5,215)	(5,093)
<b>Profit for the year</b>		<b>20,455</b>	<b>16,871</b>	<b>15,873</b>
Profit attributable to shareholders of the parent company		19,133	15,789	15,081
Profit attributable to minority interests		1,322	1,082	792
		US\$	US\$	US\$
Basic earnings per ordinary share	13	1.65	1.40	1.36
Diluted earnings per ordinary share	13	1.63	1.39	1.35
Dividends per ordinary share	12	0.87	0.76	0.69



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*The accompanying notes on pages 344 to 452, the audited sections of the [Report of the Directors: The Management of Risk] on pages 92 to 288, [Critical accounting policies] on pages 132 to 134 and [Off-balance sheet arrangements and special purpose entities] on pages 183 to 191 form an integral part of these financial statements.*

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**Financial Statements** (continued)**Consolidated balance sheet at 31 December 2007**

	<i>Notes</i>	<b>2007 US\$m</b>	2006 US\$m
<b>ASSETS</b>			
Cash and balances at central banks		<b>21,765</b>	12,732
Items in the course of collection from other banks		<b>9,777</b>	14,144
Hong Kong Government certificates of indebtedness		<b>13,893</b>	13,165
Trading assets	16	<b>445,968</b>	328,147
Financial assets designated at fair value	17	<b>41,564</b>	20,573
Derivatives	18	<b>187,854</b>	103,702
Loans and advances to banks	33	<b>237,366</b>	185,205
Loans and advances to customers	33	<b>981,548</b>	868,133
Financial investments	19	<b>283,000</b>	204,806
Interests in associates and joint ventures	21	<b>10,384</b>	8,396
Goodwill and intangible assets	22	<b>39,689</b>	37,335
Property, plant and equipment	23	<b>15,694</b>	16,424
Other assets	25	<b>39,493</b>	29,823
Current tax asset		<b>896</b>	380
Deferred tax asset	11	<b>5,284</b>	3,241
Prepayments and accrued income		<b>20,091</b>	14,552
		<hr/>	<hr/>
Total assets		<b>2,354,266</b>	1,860,758
		<hr/>	<hr/>
<b>LIABILITIES AND EQUITY</b>			
<b>Liabilities</b>			
Hong Kong currency notes in circulation		<b>13,893</b>	13,165
Deposits by banks	33	<b>132,181</b>	99,694
Customer accounts	33	<b>1,096,140</b>	896,834
Items in the course of transmission to other banks		<b>8,672</b>	12,625
Trading liabilities	26	<b>314,580</b>	226,608
Financial liabilities designated at fair value	27	<b>89,939</b>	70,211
Derivatives	18	<b>183,393</b>	101,478
Debt securities in issue	28	<b>246,579</b>	230,325
Retirement benefit liabilities	8	<b>2,893</b>	5,555
Other liabilities	29	<b>35,013</b>	28,019
Current tax liability		<b>2,559</b>	1,805
Liabilities under insurance contracts	30	<b>42,606</b>	17,670
Accruals and deferred income		<b>21,766</b>	16,310
Provisions	31	<b>1,958</b>	1,763
Deferred tax liability	11	<b>1,859</b>	1,096
Subordinated liabilities	32	<b>24,819</b>	22,672
		<hr/>	<hr/>
Total liabilities		<b>2,218,850</b>	1,745,830
		<hr/>	<hr/>
<b>Equity</b>			
Called up share capital	38	<b>5,915</b>	5,786
Share premium account	39	<b>8,134</b>	7,789
Other reserves	39	<b>33,014</b>	29,380
Retained earnings	39	<b>81,097</b>	65,397

Total shareholders' equity		<b>128,160</b>	108,352
Minority interests	37	<b>7,256</b>	6,576
		<b>135,416</b>	114,928
Total equity and liabilities		<b>2,354,266</b>	1,860,758

*The accompanying notes on pages 344 to 452, the audited sections of the Report of the Directors: The Management of Risk on pages 192 to 288, Critical accounting policies on pages 132 to 134 and Off-balance sheet arrangements and special purpose entities on pages 183 to 191 form an integral part of these financial statements.*

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S K Green, *Group Chairman*

[Back to Contents](#)**Consolidated statement of recognised income and expense for the year ended 31 December 2007**

	<b>2007</b>	2006	2005
	<b>US\$m</b>	US\$m	US\$m
Available-for-sale investments:			
□ fair value gains/(losses) taken to equity	<b>756</b>	1,582	(400)
□ fair value gains transferred to income statement on disposal or impairment	<b>(1,740)</b>	(644)	(240)
Cash flow hedges:			
□ fair value gains/(losses) taken to equity	<b>625</b>	1,554	(92)
□ fair value gains transferred to income statement	<b>(1,886)</b>	(2,198)	(106)
Share of changes in equity of associates and joint ventures	<b>372</b>	20	161
Exchange differences	<b>5,946</b>	4,675	(4,257)
Actuarial gains/(losses) on defined benefit plans	<b>2,167</b>	(78)	(812)
	<b>6,240</b>	4,911	(5,746)
Tax on items taken directly to equity	<b>(226)</b>	(44)	437
Total income and expense taken to equity during the year	<b>6,014</b>	4,867	(5,309)
Profit for the year	<b>20,455</b>	16,871	15,873
Total recognised income and expense for the year	<b>26,469</b>	21,738	10,564
Effect of change in accounting policy			
IFRSs transition adjustment at 1 January 2005 <sup>1</sup>	□	□	(8,824)
	<b>26,469</b>	21,738	1,740
Total recognised income and expense for the year attributable to:			
□ shareholders of the parent company	<b>24,801</b>	20,527	9,912
□ minority interests	<b>1,668</b>	1,211	652
	<b>26,469</b>	21,738	10,564

<sup>1</sup> For an explanation of the IFRSs transition adjustment at 1 January 2005, see Note 46 on the Financial Statements in the Annual Report and Accounts 2005.

The accompanying notes on pages 344 to 452, the audited sections of the □Report of the Directors: The Management of Risk□ on pages 192 to 288, □Critical accounting policies□ on pages 132 to 134 and □Off-balance sheet arrangements and special purpose entities□ on pages 183 to 191 form an integral part of these financial statements.

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HSBC HOLDINGS PLC

**Financial Statements** (continued)**Consolidated cash flow statement for the year ended 31 December 2007**

	<i>Notes</i>	<b>2007 US\$m</b>	2006 US\$m	2005 US\$m
<b>Cash flows from operating activities</b>				
Profit before tax		<b>24,212</b>	22,086	20,966
Adjustments for:				
☐ non-cash items included in profit before tax	40	<b>21,662</b>	14,956	11,404
☐ change in operating assets	40	<b>(176,538)</b>	(175,317)	(91,753)
☐ change in operating liabilities	40	<b>250,095</b>	237,378	72,212
☐ elimination of exchange differences		<b>(18,563)</b>	(12,114)	2,580
☐ net gain from investing activities		<b>(2,209)</b>	(2,014)	(692)
☐ share of profits in associates and joint ventures		<b>(1,503)</b>	(846)	(644)
☐ dividends received from associates		<b>363</b>	97	114
☐ contribution paid to defined benefit plans		<b>(1,393)</b>	(547)	(2,547)
☐ tax paid		<b>(5,088)</b>	(4,946)	(4,619)
Net cash from operating activities		<b>91,038</b>	78,733	7,021
<b>Cash flows from investing activities</b>				
Purchase of financial investments		<b>(260,980)</b>	(286,316)	(378,103)
Proceeds from the sale and maturity of financial investments		<b>238,647</b>	273,774	368,696
Purchase of property, plant and equipment		<b>(2,720)</b>	(2,400)	(2,887)
Proceeds from the sale of property, plant and equipment		<b>3,178</b>	2,504	620
Proceeds from the sale of loan portfolios		<b>1,665</b>	2,048	☐
Net purchase of intangible assets		<b>(950)</b>	(852)	(849)
Net cash outflow from acquisition of and increase in stake of subsidiaries		<b>(623)</b>	(1,185)	(1,662)
Net cash inflow from disposal of subsidiaries		<b>187</b>	62	705
Net cash outflow from acquisition of and increase in stake of associates		<b>(351)</b>	(585)	(2,569)
Net cash inflow from the consolidation of funds		<b>1,600</b>	☐	☐
Proceeds from disposal of associates		<b>69</b>	874	422
Net cash used in investing activities		<b>(20,278)</b>	(12,076)	(15,627)
<b>Cash flows from financing activities</b>				
Issue of ordinary share capital		<b>474</b>	1,010	690
Issue of preference shares		☐	374	1,298
Net purchases and sales of own shares for market-making and investment purposes		<b>126</b>	46	(55)
Purchases of own shares to meet share awards and share option awards		<b>(636)</b>	(575)	(766)
On exercise of share options		<b>104</b>	173	277
Subordinated loan capital issued		<b>5,705</b>	5,948	2,093
Subordinated loan capital repaid		<b>(689)</b>	(903)	(1,121)
Dividends paid to shareholders of the parent company		<b>(6,003)</b>	(5,927)	(5,935)
Dividends paid to minority interests		<b>(718)</b>	(710)	(508)

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Net cash used in financing activities		<b>(1,637)</b>	(564)	(4,027)
<b>Net increase/(decrease) in cash and cash equivalents</b>		<b>69,123</b>	66,093	(12,633)
Cash and cash equivalents at 1 January		<b>215,486</b>	141,307	160,956
Exchange differences in respect of cash and cash equivalents		<b>12,400</b>	8,086	(7,016)
Cash and cash equivalents at 31 December	40	<b>297,009</b>	215,486	141,307

1 *Adjustment to bring changes between opening and closing balance sheet amounts to average rates. This is not done on a line-by-line basis, as details cannot be determined without unreasonable expense.*

*The accompanying notes on pages 344 to 452, the audited sections of the [Report of the Directors: The Management of Risk] on pages 192 to 288, [Critical accounting policies] on pages 132 to 134 and [Off-balance sheet arrangements and special purpose entities] on pages 183 to 191 form an integral part of these financial statements.*

[Back to Contents](#)**HSBC Holdings balance sheet at 31 December 2007**

	Notes	2007 US\$m	2006 (restated) US\$m
<b>ASSETS</b>			
Cash at bank and in hand:			
□ balances with HSBC undertakings		<b>360</b>	729
Derivatives	18	<b>2,660</b>	1,599
Loans and advances to HSBC undertakings	33	<b>17,242</b>	14,456
Financial investments		<b>3,022</b>	3,614
Investments in subsidiaries <sup>1</sup>	24	<b>69,411</b>	63,265
Property, plant and equipment		<b>1</b>	1
Other assets		<b>21</b>	25
Current tax assets		□	31
Deferred tax asset	11	7	35
Prepayments and accrued income		<b>224</b>	41
		<hr/>	<hr/>
Total assets		<b>92,948</b>	83,796
		<hr/>	<hr/>
<b>LIABILITIES AND EQUITY</b>			
<b>Liabilities</b>			
Amounts owed to HSBC undertakings	33	<b>2,969</b>	3,100
Financial liabilities designated at fair value	27	<b>18,683</b>	14,070
Derivatives	18	<b>44</b>	177
Other liabilities	29	<b>1,405</b>	1,517
Current tax liabilities		<b>322</b>	□
Accruals and deferred income		<b>150</b>	111
Subordinated liabilities	32	<b>8,544</b>	8,423
		<hr/>	<hr/>
Total liabilities		<b>32,117</b>	27,398
		<hr/>	<hr/>
<b>Equity</b>			
Called up share capital	38	<b>5,915</b>	5,786
Share premium account		<b>8,134</b>	7,789
Merger reserve and other reserves		<b>28,942</b>	28,942
Other reserves		<b>3,631</b>	3,293
Retained earnings		<b>14,209</b>	10,588
		<hr/>	<hr/>
Total equity		<b>60,831</b>	56,398
		<hr/>	<hr/>
Total equity and liabilities		<b>92,948</b>	83,796
		<hr/>	<hr/>

<sup>1</sup> On 1 January 2007, HSBC Holdings adopted IFRIC 11. Comparative information has been restated accordingly. See Note 1a.

The accompanying notes on pages 344 to 452, the audited sections of the □Report of the Directors: The Management of Risk□ on pages 192 to 288, □Critical accounting policies□ on pages 132 to 134 and □Off-balance sheet arrangements and special purpose entities □ on pages 183 to 191 form an integral part of these financial statements.

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S K Green, Group Chairman





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HSBC HOLDINGS PLC

**Financial Statements** (continued)**HSBC Holdings statement of changes in total equity for the year ended 31 December 2007**

	<b>2007</b>	2006
	<b>US\$m</b>	<i>(restated)</i> US\$m
<b>Called up share capital</b>		
At 1 January	<b>5,786</b>	5,667
Shares issued in connection with the early settlement of HSBC Finance 8.875 per cent Adjustable Conversion-Rate Equity Security Units	□	2
Shares issued under employee share plans	<b>17</b>	38
Shares issued in lieu of dividends	<b>112</b>	79
	<hr/>	<hr/>
At 31 December	<b>5,915</b>	5,786
	<hr/>	<hr/>
<b>Share premium account</b>		
At 1 January	<b>7,789</b>	6,896
Shares issued under employee share plans	<b>460</b>	975
Shares issued in lieu of dividends and amounts arising thereon	<b>(115)</b>	(82)
	<hr/>	<hr/>
At 31 December	<b>8,134</b>	7,789
	<hr/>	<hr/>
<b>Merger reserve and other reserves</b>		
At 1 January and 31 December	<b>28,942</b>	28,942
	<hr/>	<hr/>
<b>Other reserves</b>		
Available-for-sale fair value reserve		
At 1 January	<b>246</b>	337
Fair value changes taken to equity <sup>1</sup>	<b>246</b>	(121)
Tax on items taken directly to equity <sup>1</sup>	<b>(10)</b>	30
	<hr/>	<hr/>
At 31 December	<b>482</b>	246
	<hr/>	<hr/>
Share-based payment reserve <sup>2</sup>		
At 1 January	<b>2,111</b>	1,535
Exercise and lapse of share options and vesting of share awards	<b>(751)</b>	(623)
Cost of share-based payment arrangements	<b>29</b>	58
Equity investments granted to employees of subsidiaries under employee share plans	<b>818</b>	1,143
Other movements	<b>(239)</b>	(2)
	<hr/>	<hr/>
At 31 December	<b>1,968</b>	2,111
	<hr/>	<hr/>
Other paid-in capital		
At 1 January	<b>936</b>	650
Exercise and lapse of share options	<b>245</b>	286
	<hr/>	<hr/>
At 31 December	<b>1,181</b>	936

Total other reserves at 31 December	<b>3,631</b>	3,293
<b>Retained earnings</b>		
At 1 January	<b>10,588</b>	9,501
Profit for the year attributable to shareholders	<b>9,499</b>	7,139
Dividends to shareholders of the parent company	<b>(10,241)</b>	(8,769)
Amounts arising on shares in lieu of dividends	<b>4,354</b>	2,528
Own shares adjustments	<b>16</b>	157
Tax on share based payments	<b>(7)</b>	9
Exchange differences and other movements <sup>1</sup>	□	23
At 31 December <sup>3</sup>	<b>14,209</b>	10,588

1 *The total net income/(expense) taken directly to equity during the year was US\$229 million (2006: US\$(59) million).*

2 *On 1 January 2007, HSBC Holdings adopted IFRIC 11. Comparative information has been restated accordingly. See Note 1a.*

3 *Retained earnings include 30,706,713 (US\$554 million) of own shares held to fund employee share plans (2006: 35,639,856, US\$544 million).*

*The accompanying notes on pages 344 to 452, the audited sections of the □Report of the Directors: The Management of Risk□ on pages 192 to 288, □Critical accounting policies□ on pages 132 to 134 and □Off-balance sheet arrangements and special purpose entities □ on pages 183 to 191 form an integral part of these financial statements.*

[Back to Contents](#)**HSBC Holdings cash flow statement for the year ended 31 December 2007**

	<i>Notes</i>	<b>2007</b> <b>US\$m</b>	2006 US\$m
<b>Cash flows from operating activities</b>			
Profit before tax		<b>9,598</b>	6,974
Adjustments for:			
□ non-cash items included in profit before tax	40	<b>10</b>	58
□ change in operating assets	40	<b>(4,059)</b>	(1,827)
□ change in operating liabilities	40	<b>179</b>	1,056
□ elimination of exchange differences		<b>(26)</b>	(29)
□ net gain from investing activities		<b>(12)</b>	(8)
□ tax received		<b>268</b>	219
		<hr/>	<hr/>
Net cash from operating activities		<b>5,958</b>	6,443
		<hr/>	<hr/>
<b>Cash flows from investing activities</b>			
Net cash outflow from acquisition of and increase in stake of subsidiaries		<b>(5,133)</b>	(4,440)
		<hr/>	<hr/>
Net cash used in investing activities		<b>(5,133)</b>	(4,440)
		<hr/>	<hr/>
<b>Cash flows from financing activities</b>			
Issue of ordinary share capital		<b>474</b>	1,010
Purchases of own shares to meet share awards and share option awards		<b>(96)</b>	(46)
On exercise of share options		<b>72</b>	127
Subordinated loan capital issued		<b>4,359</b>	2,806
Dividends paid		<b>(6,003)</b>	(5,927)
		<hr/>	<hr/>
Net cash used in financing activities		<b>(1,194)</b>	(2,030)
		<hr/>	<hr/>
<b>Net increase/(decrease) in cash and cash equivalents</b>			
		<b>(369)</b>	(27)
Cash and cash equivalents at 1 January		<b>729</b>	756
		<hr/>	<hr/>
Cash and cash equivalents at 31 December	40	<b>360</b>	729
		<hr/>	<hr/>

1 *Adjustment to bring changes between opening and closing balance sheet amounts to average rates. This is not done on a line-by-line basis, as details cannot be determined without unreasonable expense. The accompanying notes on pages 344 to 452, the audited sections of the □Report of the Directors: The Management of Risk□ on pages 192 to 288, □Critical accounting policies□ on pages 132 to 134 and □Off-balance sheet arrangements and special purpose entities□ on pages 183 to 191 form an integral part of these financial statements.*

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HSBC HOLDINGS PLC

**Notes on the Financial Statements****Note 1****1 Basis of preparation****(a) Compliance with International Financial Reporting Standards**

The consolidated financial statements of HSBC and the separate financial statements of HSBC Holdings have been prepared in accordance with International Financial Reporting Standards (IFRSs) as endorsed by the EU. EU-endorsed IFRSs may differ from IFRSs as published by the International Accounting Standards Board (IASB) if, at any point in time, new or amended IFRSs have not been endorsed by the EU. At 31 December 2007, there were no unendorsed standards effective for the year ended 31 December 2007 affecting these consolidated and separate financial statements, and there was no difference between IFRSs endorsed by the EU and IFRSs issued by the IASB in terms of their application to HSBC. Accordingly, HSBC's financial statements for the year ended 31 December 2007 are prepared in accordance with IFRSs as issued by the IASB.

IFRSs comprise accounting standards issued by the IASB and its predecessor body and interpretations issued by the International Financial Reporting Interpretations Committee (IFRIC) and its predecessor body.

On 1 January 2007, HSBC adopted the following IFRIC interpretations:

- IFRIC 10 [Interim Financial Reporting and Impairment], which had no significant effect on the consolidated financial statements of HSBC Holdings; and
- IFRIC 11 [Group and Treasury Share Transactions] (IFRIC 11). On application of this interpretation, HSBC Holdings recognises all share-based payment transactions as equity-settled in its separate financial statements. The adoption of IFRIC 11 had no effect on the consolidated financial statements of HSBC. However, in the separate financial statements of HSBC Holdings, the effect was to increase both [Investments in subsidiaries] and [Share-based payment reserve] by US\$909 million in 2006. This change in accounting policy was made in accordance with the transitional provisions of IFRIC 11, which state that IFRIC 11 shall be applied retrospectively in accordance with IAS 8 [Accounting Policies, Changes in Accounting Estimates and Errors], subject to the transitional provisions of IFRS 2 [Share-based Payment].

**(b) Differences between IFRSs and Hong Kong Financial Reporting Standards**

As stated in Note 46, there are no significant differences between IFRSs and Hong Kong Financial Reporting Standards. The Notes on the Financial Statements, taken together with the Report of the Directors, include the aggregate of all disclosures necessary to satisfy IFRSs and Hong Kong reporting requirements.

**(c) Presentation of information**

Disclosures under IFRS 4 and IFRS 7 relating to the nature and extent of risks have been included in the audited sections of the [Report of the Directors: The Management of Risk] on pages 192 to 288.

Capital disclosures under IAS 1 [Presentation of Financial Statements] have been included in the audited sections of [Capital management and allocation] on pages 282 to 288.

Disclosures relating to [Off-balance sheet arrangements and special purpose entities] are set out below on pages 183 to 191 and are also audited.

In publishing the parent company financial statements here together with the Group financial statements, HSBC Holdings has taken advantage of the exemption in section 230 of the Companies Act 1985 not to present its individual income statement and related notes that form a part of these financial statements.

HSBC has taken advantage of the exemption under Regulation 7 of the Partnerships and Unlimited Companies (Accounts) Regulations 1993 from certain partnerships that are consolidated by HSBC presenting their own individual financial statements under IFRSs.

The functional currency of HSBC Holdings plc is the US dollar, which is also the presentational currency of the consolidated financial statements of HSBC.

(d) Comparative information

As required by US public company reporting requirements, these consolidated financial statements include two years of comparative information for the consolidated income statement, consolidated cash flow statement, consolidated statement of recognised income and expense and related notes on the financial statements.

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(e) Use of estimates and assumptions

The preparation of financial information requires the use of estimates and assumptions about future conditions. Use of available information and application of judgement are inherent in the formation of estimates. Actual results in the future may differ from those reported. In this regard, management believes that the critical accounting policies where judgement is necessarily applied are those which relate to loan impairment, goodwill impairment and the valuation of financial instruments (see [Critical Accounting Policies] on pages 132 to 134 which form an integral part of these financial statements).

Further information about key assumptions concerning the future, and other key sources of estimation uncertainty, are set out in these notes on the financial statements.

(f) Consolidation

The consolidated financial statements of HSBC comprise the financial statements of HSBC Holdings and its subsidiaries made up to 31 December, with the exception of the banking and insurance subsidiaries of HSBC Bank Argentina, whose financial statements are made up to 30 June annually to comply with local regulations. Accordingly, HSBC uses their audited interim financial statements, drawn up to 31 December annually.

Newly acquired subsidiaries are consolidated from the date that HSBC gains control. The purchase method of accounting is used to account for the acquisition of subsidiaries by HSBC. The cost of an acquisition is measured at the fair value of the consideration given at the date of exchange, together with costs directly attributable to that acquisition. The acquired identifiable assets, liabilities and contingent liabilities are measured at their fair values at the date of acquisition. Any excess of the cost of acquisition over the fair value of HSBC's share of the identifiable assets, liabilities and contingent liabilities acquired is recorded as goodwill. If the cost of acquisition is less than the fair value of HSBC's share of the identifiable assets, liabilities and contingent liabilities of the business acquired, the difference is recognised immediately in the income statement.

Entities that are controlled by HSBC are consolidated until the date that control ceases.

In the context of Special Purpose Entities ([SPEs]), the following circumstances may indicate a relationship in which, in substance, HSBC controls and, consequently, consolidates an SPE:

- the activities of the SPE are being conducted on behalf of HSBC according to its specific business needs so that HSBC obtains benefits from the SPE's operation;
- HSBC has the decision-making powers to obtain the majority of the benefits of the activities of the SPE or, by setting up an [autopilot] mechanism, HSBC has delegated these decision-making powers;
- HSBC has rights to obtain the majority of the benefits of the SPE and therefore may be exposed to risks incident to the activities of the SPE; or
- HSBC retains the majority of the residual or ownership risks related to the SPE or its assets in order to obtain benefits from its activities.

HSBC performs a re-assessment of consolidation whenever there is a change in the substance of the relationship between HSBC and an SPE.

All intra-HSBC transactions are eliminated on consolidation.

The consolidated financial statements of HSBC also include the attributable share of the results and reserves of joint ventures and associates. These are based on financial statements made up to 31 December, with the exception of the Bank of Communications, Ping An Insurance and Industrial Bank which are included on the basis of financial statements made up for the twelve months to 30 September. These are equity accounted three months in arrears in order to meet the requirements of the Group's reporting timetable. HSBC has taken into account changes in the period from 1 October to 31 December that would have materially affected its results.

(g) Future accounting developments

**Standards and Interpretations issued by the IASB and endorsed by the EU**

IFRS 8 "Operating Segments" (IFRS 8), which replaces IAS 14 "Segment Reporting" (IAS 14), was issued on 30 November 2006 and is effective for annual periods beginning on or after 1 January 2009. This standard specifies how an entity should report information about its operating segments, based on information about the

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HSBC HOLDINGS PLC

**Notes on the Financial Statements** (continued)**Notes 1 and 2**

components of the entity that the chief operating decision maker uses to make operating decisions. HSBC currently presents two sets of segments in accordance with IAS 14, one geographical and one based on customer groups, which reflect the way the businesses of the Group are managed. HSBC expects to adopt IFRS 8 with effect from 1 January 2009, and will accordingly present segmental information which reflects the operating segments used to make operating decisions at that time.

**Standards and Interpretations issued by the IASB but not endorsed by the EU**

The IASB issued a revised IAS 23 *Borrowing Costs* on 29 March 2007, which is applicable for annual periods beginning on or after 1 January 2009. The revised standard eliminates the option of recognising borrowing costs immediately as an expense, to the extent that they are directly attributable to the acquisition, construction or production of a qualifying asset. HSBC does not expect adoption of the revised standard to have a significant effect on the consolidated financial statements.

IFRIC 12 *Service Concession Arrangements* (IFRIC 12) was issued on 30 November 2006 and is effective for annual periods beginning on or after 1 January 2008. IFRIC 12 provides guidance on service concession arrangements by which a government or other public sector entity grants contracts for the supply of public services to private sector operators. IFRIC 12 addresses how service concession operators should apply existing IFRSs to account for the obligations they undertake and the rights they receive in service concession arrangements. IFRIC 12 is unlikely to have a significant effect on HSBC.

IFRIC 13 *Customer Loyalty Programmes* (IFRIC 13) was issued on 28 June 2007 and is effective for annual periods beginning on or after 1 July 2008. IFRIC 13 addresses how companies that grant their customers loyalty award credits (often called "points") when buying goods or services should account for their obligation to provide free or discounted goods and services, if and when the customers redeem the points. IFRIC 13 requires companies to allocate some of the proceeds of the initial sale to the award credits and recognise these proceeds as revenue only when they have fulfilled their obligations to provide goods or services. HSBC is currently assessing the effect of this interpretation on the consolidated financial statements.

IFRIC 14 *IAS 19 The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction* (IFRIC 14) was issued on 5 July 2007 and is effective for annual periods beginning on or after 1 January 2008. IFRIC 14 provides guidance regarding the circumstances under which refunds and future reductions in contributions from a defined benefit plan can be regarded as available to an entity for the purpose of recognising a net defined benefit asset. Additionally, in jurisdictions where there is both a minimum funding requirement and restrictions over the amounts that companies can recover from the plan, either as refunds or reductions in contributions, additional liabilities may need to be recognised. HSBC is currently assessing the effect of this interpretation on the consolidated financial statements.

A revised IAS 1 *Presentation of Financial Statements*, which is applicable for annual periods beginning on or after 1 January 2009, was issued on 6 September 2007. The revised standard aims to improve users' ability to analyse and compare information given in financial statements. Adoption of the revised standard will have no effect on the results reported in HSBC's consolidated financial statements but will change the presentation of the results and financial position of HSBC in certain respects.

The IASB issued an amendment to IFRS 2 *Share-based Payment* on 17 January 2008. The amendment, which is applicable for annual periods beginning on or after 1 January 2009, clarifies that vesting conditions comprise only service conditions and performance conditions. It also specifies the accounting treatment for a failure to meet a non-vesting condition. Adoption of the amendment is unlikely to have a significant effect on HSBC's consolidated financial statements.



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A revised IFRS 3 [Business Combinations] and an amended IAS 27 [Consolidated and Separate Financial Statements], were issued on 10 January 2008. The revisions to the standards apply prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual financial reporting period beginning on or after 1 July 2009. The main changes under the standards are that:

- acquisition-related costs are recognised as expenses in the income statement in the period they are incurred;
- equity interests held prior to control being obtained are remeasured to fair value at the time control is obtained, and any gain or loss is recognised in the income statement;

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- changes in a parent's ownership interest in a subsidiary that do not result in a change of control are treated as transactions between equity holders and reported in equity; and
- An option is available, on a transaction-by-transaction basis, to measure any non-controlling interests (previously referred to as minority interests) in the entity acquired either at fair value, or at the non-controlling interest's proportionate share of the net identifiable assets of the entity acquired.
- The effect that the changes will have on the results and financial position of HSBC will depend on the incidence and timing of business combinations occurring on or after 1 January 2010.
- The IASB issued amendments to IAS 32 "Financial Instruments: Presentation" and IAS 1 "Presentation of Financial Statements", "Puttable Financial Instruments and Obligations Arising on Liquidation", on 14 February 2008. The amendments are applicable for annual periods beginning on or after 1 January 2009. HSBC is currently assessing the effect of the amendments, if any, on the consolidated financial statements.

## 2 Summary of significant accounting policies

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### (a) Interest income and expense

Interest income and expense for all financial instruments except for those classified as held for trading or designated at fair value (other than debt securities issued by HSBC and derivatives managed in conjunction with such debt securities issued) are recognised in "Interest income" and "Interest expense" in the income statement using the effective interest method. The effective interest method is a way of calculating the amortised cost of a financial asset or a financial liability (or groups of financial assets or financial liabilities) and of allocating the interest income or interest expense over the relevant period.

The effective interest rate is the rate that exactly discounts estimated future cash receipts or payments through the expected life of the financial instrument or, where appropriate, a shorter period, to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, HSBC estimates cash flows considering all contractual terms of the financial instrument but not future credit losses. The calculation includes all amounts paid or received by HSBC that are an integral part of the effective interest rate of a financial instrument, including transaction costs and all other premiums or discounts.

Interest on impaired financial assets is calculated by applying the original effective interest rate of the financial asset to the carrying amount as reduced by any allowance for impairment.

### (b) Non-interest income

HSBC earns **fee income** from a diverse range of services provided to its customers. Fee income is accounted for as follows:

- income earned on the execution of a significant act is recognised as revenue when the act is completed (for example, fees arising from negotiating, or participating in the negotiation of, a transaction for a third party, such as the arrangement for the acquisition of shares or other securities);
- income earned from the provision of services is recognised as revenue as the services are provided (for example, asset management, portfolio and other management advisory and service fees); and
- income which forms an integral part of the effective interest rate of a financial instrument is recognised as an adjustment to the effective interest rate (for example, certain loan commitment fees) and recorded in "Interest income" (Note 2a).

**Net trading income** comprises all gains and losses from changes in the fair value of financial assets and financial liabilities held for trading, together with related interest income, expense and dividends.

**Net income from financial instruments designated at fair value** includes all gains and losses from changes in the fair value of financial assets and financial liabilities designated at fair value through profit or loss. Interest income and expense and dividend income arising on these financial instruments are also

included, except for debt securities issued and derivatives managed in conjunction with debt securities issued. Interest on these instruments is presented in [Interest expense].

**Dividend income** is recognised when the right to receive payment is established. This is the ex-dividend date for equity securities.

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**Notes on the Financial Statements** (continued)**Note 2**

## (c) Segment reporting

HSBC is organised into five geographical regions, Europe, Hong Kong, Rest of Asia-Pacific, North America and Latin America, and manages its business through four customer groups: Personal Financial Services; Commercial Banking; Global Banking and Markets; and Private Banking. The main items reported in the [Other] segment are the income and expenses of wholesale insurance operations, certain property activities, unallocated investment activities including hsbc.com, centrally held investment companies and HSBC's holding company and financing operations. Segment income and expenses include transfers between geographical regions and transfers between customer groups. These transfers are conducted on arm's length terms and conditions.

In HSBC's segmental analysis of the income statement by customer groups and global businesses, net trading income comprises all gains and losses from changes in the fair value of financial assets and financial liabilities classified as held for trading, together with third party and intra-segment interest income and interest expense, and dividends received; in the consolidated income statement, intra-segment interest income and expense are eliminated.

## (d) Determination of fair value

All financial instruments are recognised initially at fair value. In the normal course of business, the fair value of a financial instrument on initial recognition is the transaction price (that is, the fair value of the consideration given or received). In certain circumstances, however, the fair value will be based on other observable current market transactions in the same instrument, without modification or repackaging, or on a valuation technique whose variables include only data from observable markets, such as interest rate yield curves, option volatilities and currency rates. When such evidence exists, HSBC recognises a trading gain or loss on inception of the financial instrument. When unobservable market data have a significant impact on the valuation of financial instruments, the entire initial difference in fair value indicated by the valuation model from the transaction price is not recognised immediately in the income statement but is recognised over the life of the transaction on an appropriate basis, or when the inputs become observable, or the transaction matures or is closed out, or when HSBC enters into an offsetting transaction.

Subsequent to initial recognition, the fair values of financial instruments measured at fair value that are quoted in active markets are based on bid prices for assets held and offer prices for liabilities issued. When independent prices are not available, fair values are determined by using valuation techniques which refer to observable market data. These include comparison with similar instruments where market observable prices exist, discounted cash flow analysis, option pricing models and other valuation techniques commonly used by market participants. For financial instruments, fair values may be determined in whole or in part using valuation techniques based on assumptions that are not supported by prices from current market transactions or observable market data.

Factors such as bid-offer spread, credit profile and model uncertainty are taken into account, as appropriate, when fair values are calculated using valuation techniques. Valuation techniques incorporate assumptions that other market participants would use in their valuations, including assumptions about interest rate yield curves, exchange rates, volatilities, and prepayment and default rates. Where a portfolio of financial instruments has quoted prices in an active market, the fair value of the instruments are calculated as the product of the number of units and quoted price and no block discounts are made.

If the fair value of a financial asset measured at fair value becomes negative, it is recorded as a financial liability until its fair value becomes positive, at which time it is recorded as a financial asset.

The fair values of financial liabilities are measured using quoted market prices where available, or using valuation techniques. These fair values include market participants' assessments of the appropriate credit spread to apply to HSBC's liabilities. The amount of change during the period, and cumulatively, in the fair value of designated financial liabilities and loans and advances that is attributable to changes in their credit spread is determined as the amount of change in the fair value that is not attributable to changes in market conditions that give rise to market risk.

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(e) Loans and advances to banks and customers

Loans and advances to banks and customers include loans and advances originated by HSBC which are not classified either as held for trading or designated at fair value. Loans and advances are recognised when cash is advanced to borrowers. They are derecognised when either borrowers repay their obligations, or the loans are sold or written off, or substantially all the risks and rewards of ownership are transferred. They are initially recorded at fair value plus any directly attributable transaction costs and are subsequently measured at amortised cost using the effective interest method, less impairment losses. Where loans and advances are hedged by derivatives designated and qualifying as fair value hedges, the carrying value of the loans and advances so hedged includes a fair value adjustment for the hedged risk only.

For certain leveraged finance and syndicated lending activities, HSBC may commit to underwrite loans on fixed contractual terms for specified periods of time, where the drawdown of the loan is contingent upon certain future events outside the control of HSBC. Where the loan arising from the lending commitment is expected to be held for trading, the commitment to lend is recorded as a trading derivative. Where it is not HSBC's intention to trade the loan, a provision is only recorded where it is probable that HSBC will incur a loss as a result of the loan commitment. This may occur, for example, where a loss of principal is probable or the interest rate charged on the loan is lower than the cost of funding. On inception of the loan, the hold portion is recorded at its fair value. Where this fair value is lower than the cash amount advanced (for example, due to the rate of interest charged on the loan being below the market rate of interest), the write down is charged to the income statement. The write down will be recovered over the life of the loan, through the recognition of interest income using the effective interest rate method, unless the loan is impaired. The write down is recorded as a reduction to other operating income.

(f) Impairment of loans and advances

Losses for impaired loans are recognised promptly when there is objective evidence that impairment of a loan or portfolio of loans has occurred. Impairment allowances are calculated on individual loans and on groups of loans assessed collectively. Impairment losses are recorded as charges to the income statement. The carrying amount of impaired loans on the balance sheet is reduced through the use of impairment allowance accounts. Losses expected from future events are not recognised.

**Individually assessed loans and advances**

For all loans that are considered individually significant, HSBC assesses on a case-by-case basis at each balance sheet date whether there is any objective evidence that a loan is impaired. For those loans where objective evidence of impairment exists, impairment losses are determined considering the following factors:

- HSBC's aggregate exposure to the customer;
- the viability of the customer's business model and their capacity to trade successfully out of financial difficulties and generate sufficient cash flow to service debt obligations;
- the amount and timing of expected receipts and recoveries;
- the likely dividend available on liquidation or bankruptcy;
- the extent of other creditors' commitments ranking ahead of, or *pari passu* with, HSBC and the likelihood of other creditors continuing to support the company;
- the complexity of determining the aggregate amount and ranking of all creditor claims and the extent to which legal and insurance uncertainties are evident;
- the realisable value of security (or other credit mitigants) and likelihood of successful repossession;

- the likely deduction of any costs involved in recovery of amounts outstanding;
- the ability of the borrower to obtain, and make payments in, the currency of the loan if not denominated in local currency; and
- when available, the secondary market price of the debt.

Impairment losses are calculated by discounting the expected future cash flows of a loan at its original effective interest rate, and comparing the resultant present value with the loan's current carrying amount.

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**Notes on the Financial Statements** (continued)*Note 2***Collectively assessed loans and advances**

Impairment is assessed on a collective basis in two circumstances:

- to cover losses which have been incurred but have not yet been identified on loans subject to individual assessment; and
- for homogeneous groups of loans that are not considered individually significant.

*Incurred but not yet identified impairment*

Individually assessed loans for which no evidence of loss has been specifically identified on an individual basis are grouped together according to their credit risk characteristics for the purpose of calculating an estimated collective loss. This reflects impairment losses that HSBC has incurred as a result of events occurring before the balance sheet date, which HSBC is not able to identify on an individual loan basis, and that can be reliably estimated. These losses will only be individually identified in the future. As soon as information becomes available which identified losses on individual loans within the group, those loans are removed from the group and assessed on an individual basis for impairment.

The collective impairment allowance is determined after taking into account:

- historical loss experience in portfolios of similar credit risk characteristics (for example, by industry sector, loan grade or product);
- the estimated period between impairment occurring and the loss being identified and evidenced by the establishment of an appropriate allowance against the individual loan; and
- management's experienced judgement as to whether current economic and credit conditions are such that the actual level of inherent losses at the balance sheet date is likely to be greater or less than that suggested by historical experience.

The period between a loss occurring and its identification is estimated by local management for each identified portfolio.

*Homogeneous groups of loans and advances*

Statistical methods are used to determine impairment losses on a collective basis for homogeneous groups of loans that are not considered individually significant, because individual loan assessment is impracticable. Losses in these groups of loans are recorded on an individual basis when individual loans are written off, at which point they are removed from the group. Two alternative methods are used to calculate allowances on a collective basis:

- When appropriate empirical information is available, HSBC utilises roll rate methodology. This methodology employs statistical analyses of historical data and experience of delinquency and default to estimate the amount of loans that will eventually be written off as a result of the events occurring before the balance sheet date which HSBC is not able to identify on an individual loan basis, and that can be reliably estimated. Under this methodology, loans are grouped into ranges according to the number of days past due, and statistical analysis is used to estimate the likelihood that loans in each range will progress through the various stages of delinquency and ultimately prove irrecoverable. The estimated loss is the difference between the present value of expected future cash flows, discounted at the original effective interest rate of the portfolio, and the carrying amount of the portfolio. Current economic conditions are also evaluated when calculating the appropriate level of allowance required to cover inherent loss. In certain highly developed markets, sophisticated models also take into account



behavioural and account management trends as revealed in, for example, bankruptcy and rescheduling statistics.

- In other cases, when the portfolio size is small or when information is insufficient or not reliable enough to adopt a roll rate methodology, HSBC adopts a formulaic approach which allocates progressively higher percentage loss rates the longer a customer's loan is overdue. Loss rates are based on historical experience.

In normal circumstances, historical experience provides the most objective and relevant information from which to assess inherent loss within each portfolio. In certain circumstances, historical loss experience provides less relevant information about the inherent loss in a given portfolio at the balance sheet date, for example, where

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there have been changes in economic, regulatory or behavioural conditions, such that the most recent trends in the portfolio risk factors are not fully reflected in the statistical models.

These additional portfolio risk factors may include recent loan portfolio growth and product mix, unemployment rates, bankruptcy trends, geographic concentrations, loan product features (such as the ability of borrowers to repay adjustable-rate loans where reset interest rates give rise to increases in interest charges), economic conditions such as national and local trends in housing markets and interest rates, portfolio seasoning, account management policies and practices, current levels of write-offs, changes in laws and regulations and other items which can affect customer payment patterns on outstanding loans, such as natural disasters. These risk factors, where relevant, are taken into account when calculating the appropriate level of impairment allowances by adjusting the impairment allowances derived solely from historical loss experience.

Roll rates, loss rates and the expected timing of future recoveries are regularly benchmarked against actual outcomes to ensure they remain appropriate.

### **Write-off of loans and advances**

A loan (and the related impairment allowance account) is normally written off, either partially or in full, when there is no realistic prospect of recovery of the principal amount and, for a collateralised loan, when the proceeds from realising the security have been received.

### **Reversals of impairment**

If the amount of an impairment loss decreases in a subsequent period, and the decrease can be related objectively to an event occurring after the impairment was recognised, the excess is written back by reducing the loan impairment allowance account accordingly. The write back is recognised in the income statement.

### **Assets acquired in exchange for loans**

Non-financial assets acquired in exchange for loans as part of an orderly realisation are recorded as assets held for sale and reported in Other assets. The asset acquired is recorded at the lower of its fair value (less costs to sell) and the carrying amount of the loan (net of impairment allowance) at the date of exchange. No depreciation is charged in respect of assets held for sale. Any subsequent write-down of the acquired asset to fair value less costs to sell is recognised in the income statement, in Other operating income. Any subsequent increase in the fair value less costs to sell, to the extent this does not exceed the cumulative write down, is also recognised in Other operating income, together with any realised gains or losses on disposal.

### **Renegotiated loans**

Loans subject to collective impairment assessment whose terms have been renegotiated are no longer considered past due, but are treated as new loans for measurement purposes once the minimum number of payments required under the new arrangements have been received. Loans subject to individual impairment assessment, whose terms have been renegotiated, are subject to ongoing review to determine whether they remain impaired or should be considered past due. The carrying amount of loans that have been classified as renegotiated retain this classification until maturity or derecognition.

#### **(g) Trading assets and trading liabilities**

Treasury bills, debt securities, equity shares, loans, deposits, debt securities in issue, and short positions in securities are classified as held for trading if they have been acquired principally for the purpose of selling or repurchasing in the near term, or they form part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent pattern of short-term profit-taking. These financial assets or financial liabilities are recognised on trade date, when HSBC enters into contractual arrangements with counterparties to purchase or sell securities, and are normally derecognised when either sold (assets) or extinguished (liabilities). Measurement is initially at fair value, with transaction costs taken to the income statement. Subsequently, their fair values are remeasured, and all gains and losses from changes therein are recognised in the income statement in Net trading income.

as they arise.

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HSBC HOLDINGS PLC

**Notes on the Financial Statements** (continued)**Note 2**

## (h) Financial instruments designated at fair value

Financial instruments, other than those held for trading, are classified in this category if they meet one or more of the criteria set out below, and are so designated by management. HSBC may designate financial instruments at fair value when the designation:

- eliminates or significantly reduces valuation or recognition inconsistencies that would otherwise arise from measuring financial assets or financial liabilities, or recognising gains and losses on them, on different bases. Under this criterion, the main classes of financial instruments designated by HSBC are:

**Long-term debt issues.** The interest payable on certain fixed rate long-term debt securities issued has been matched with the interest on [receive fixed/pay variable] interest rate swaps as part of a documented interest rate risk management strategy. An accounting mismatch would arise if the debt securities issued were accounted for at amortised cost, because the related derivatives are measured at fair value with changes in the fair value recognised in the income statement. By designating the long-term debt at fair value, the movement in the fair value of the long-term debt will also be recognised in the income statement.

**Financial assets and financial liabilities under investment contracts .** Liabilities to customers under linked contracts are determined based on the fair value of the assets held in the linked funds, with changes recognised in the income statement. If no designation was made for the assets relating to the customer liabilities they would be classified as available-for-sale and the changes in fair value would be recorded directly in equity. These financial instruments are managed on a fair value basis and management information is also prepared on this basis.

Designation at fair value of the financial assets and liabilities under investment contracts allows the changes in fair values to be recorded in the income statement and presented in the same line.

- applies to groups of financial assets, financial liabilities or combinations thereof that are managed, and their performance evaluated, on a fair value basis in accordance with a documented risk management or investment strategy, and where information about the groups of financial instruments is reported to management on that basis. Under this criterion, certain financial assets held to meet liabilities under insurance contracts are the main class of financial instrument so designated. HSBC has documented risk management and investment strategies designed to manage such assets at fair value, taking into consideration the relationship of assets to liabilities in a way that mitigates market risks. Reports are provided to management on the fair value of the assets. Fair value measurement is also consistent with the regulatory reporting requirements under the appropriate regulations for these insurance operations.
- relates to financial instruments containing one or more embedded derivatives that significantly modify the cash flows resulting from those financial instruments, including certain debt issues and debt securities held.

The fair value designation, once made, is irrevocable. Designated financial assets and financial liabilities are recognised when HSBC enters into the contractual provisions of the arrangements with counterparties, which is generally on trade date, and are normally derecognised when sold (assets) or extinguished (liabilities). Measurement is initially at fair value, with transaction costs taken directly to the income statement.

Subsequently, the fair values are remeasured, and gains and losses from changes therein are recognised in [Net income from financial instruments designated at fair value].

(i) Financial investments

Treasury bills, debt securities and equity shares intended to be held on a continuing basis, other than those designated at fair value (Note 2h), are classified as available-for-sale or held-to-maturity. Financial investments are recognised on trade date, when HSBC enters into contractual arrangements with counterparties to purchase securities, and are normally derecognised when either the securities are sold or the borrowers repay their obligations.

- (i) Available-for-sale securities are initially measured at fair value plus direct and incremental transaction costs. They are subsequently remeasured at fair value, and changes therein are recognised in equity in the [Available-for-sale reserve] (Note 39) until the securities are either sold or impaired. When available-for-sale securities are sold, cumulative gains or losses previously recognised in equity are recognised in the income statement as [Gains less losses from financial investments].

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Interest income is recognised on available-for-sale securities using the effective interest rate method, calculated over the asset's expected life. Premiums and/or discounts arising on the purchase of dated investment securities are included in the calculation of their effective interest rates. Dividends are recognised in the income statement when the right to receive payment has been established.

At each balance sheet date an assessment is made of whether there is any objective evidence of impairment in the value of a financial asset or group of assets. This usually arises when circumstances are such that an adverse effect on future cash flows from the asset or group of assets can be reliably estimated. If an available-for-sale security is impaired, the cumulative loss (measured as the difference between the asset's acquisition cost (net of any principal repayments and amortisation) and its current fair value, less any impairment loss on that asset previously recognised in the income statement) is removed from equity and recognised in the income statement. Reversals of impairment losses are subject to contrasting treatments depending on the nature of the instrument concerned:

- if the fair value of a debt instrument classified as available-for-sale increases in a subsequent period, and the increase can be objectively related to an event occurring after the impairment loss was recognised in the income statement, the impairment loss is reversed through the income statement;
- impairment losses recognised in the income statement on equity instruments are not reversed through the income statement.

(ii) Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and fixed maturities that HSBC positively intends, and is able, to hold until maturity. Held-to-maturity investments are initially recorded at fair value plus any directly attributable transaction costs, and are subsequently measured at amortised cost using the effective interest rate method, less any impairment losses.

(j) Sale and repurchase agreements (including stock lending and borrowing)

When securities are sold subject to a commitment to repurchase them at a predetermined price (‘‘repos’’), they remain on the balance sheet and a liability is recorded in respect of the consideration received. Securities purchased under commitments to sell (‘‘reverse repos’’) are not recognised on the balance sheet and the consideration paid is recorded in ‘‘Loans and advances to banks’’ or ‘‘Loans and advances to customers’’ as appropriate. The difference between the sale and repurchase price is treated as interest and recognised over the life of the agreement.

Securities lending and borrowing transactions are generally secured, with collateral taking the form of securities or cash advanced or received. The transfer of securities to counterparties under these agreements is not normally reflected on the balance sheet. Cash collateral advanced or received is recorded as an asset or a liability respectively.

Securities borrowed are not recognised on the balance sheet. If they are sold on to third parties, an obligation to return the securities is recorded as a trading liability and measured at fair value, and any gains or losses are included in ‘‘Net trading income’’.

(k) Derivatives and hedge accounting

Derivatives are recognised initially, and are subsequently remeasured, at fair value. Fair values of exchange-traded derivatives are obtained from quoted market prices. Fair values of over-the-counter derivatives are obtained using valuation techniques, including discounted cash flow models and option pricing models.

Derivatives may be embedded in other financial instruments, for example, a convertible bond with an embedded conversion option. Embedded derivatives are treated as separate derivatives when their economic characteristics and risks are not clearly and closely related to those of the host contract; the terms of the embedded derivative would meet the definition of a stand-alone derivative if they were contained in a separate contract; and the combined contract is not held for trading or designated at fair value. These embedded derivatives are measured at fair value with changes therein recognised in the

income statement.

Derivatives are classified as assets when their fair value is positive, or as liabilities when their fair value is negative. Derivative assets and liabilities arising from different transactions are only offset if the transactions are

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HSBC HOLDINGS PLC

**Notes on the Financial Statements** (continued)*Note 2*

with the same counterparty, a legal right of offset exists, and the parties intend to settle the cash flows on a net basis.

The method of recognising fair value gains and losses depends on whether derivatives are held for trading or are designated as hedging instruments, and if the latter, the nature of the risks being hedged. All gains and losses from changes in the fair value of derivatives held for trading are recognised in the income statement. When derivatives are designated as hedges, HSBC classifies them as either: (i) hedges of the change in fair value of recognised assets or liabilities or firm commitments (□fair value hedges□); (ii) hedges of the variability in highly probable future cash flows attributable to a recognised asset or liability, or a forecast transaction (□cash flow hedges□); or (iii) a hedge of a net investment in a foreign operation (□net investment hedges□). Hedge accounting is applied to derivatives designated as hedging instruments in a fair value, cash flow or net investment hedge provided certain criteria are met.

**Hedge accounting**

At the inception of a hedging relationship, HSBC documents the relationship between the hedging instruments and the hedged items, its risk management objective and its strategy for undertaking the hedge. HSBC also requires a documented assessment, both at hedge inception and on an ongoing basis, of whether or not the hedging instruments, primarily derivatives, that are used in hedging transactions are highly effective in offsetting the changes attributable to the hedged risks in the fair values or cash flows of the hedged items. Interest on designated qualifying hedges is included in □Net interest income□.

*Fair value hedge*

Changes in the fair value of derivatives that are designated and qualify as fair value hedging instruments are recorded in the income statement, along with changes in the fair value of the hedged assets, liabilities or group thereof that are attributable to the hedged risk.

If a hedging relationship no longer meets the criteria for hedge accounting, the cumulative adjustment to the carrying amount of the hedged item is amortised to the income statement based on a recalculated effective interest rate over the residual period to maturity, unless the hedged item has been derecognised, in which case, it is released to the income statement immediately.

*Cash flow hedge*

The effective portion of changes in the fair value of derivatives that are designated and qualify as cash flow hedges is recognised in equity within the cash flow hedging reserve. Any gain or loss in fair value relating to an ineffective portion is recognised immediately in the income statement.

Amounts accumulated in equity are recycled to the income statement in the periods in which the hedged item will affect profit or loss. However, when the forecast transaction that is hedged results in the recognition of a non-financial asset or a non-financial liability, the gains and losses previously deferred in equity are transferred from equity and included in the initial measurement of the cost of the asset or liability.

When a hedging instrument expires or is sold, or when a hedge no longer meets the criteria for hedge accounting, any cumulative gain or loss existing in equity at that time remains in equity until the forecast transaction is eventually recognised in the income statement. When a forecast transaction is no longer expected to occur, the cumulative gain or loss that was reported in equity is immediately transferred to the income statement.

*Net investment hedge*



Hedges of net investments in foreign operations are accounted for in a similar way to cash flow hedges. A gain or loss on the effective portion of the hedging instrument is recognised in equity; a gain or loss on the ineffective portion is recognised immediately in the income statement. Gains and losses accumulated in equity are included in the income statement on the disposal of the foreign operation.

**Hedge effectiveness testing**

To qualify for hedge accounting, HSBC requires that at the inception of the hedge and throughout its life, each hedge must be expected to be highly effective (prospective effectiveness), and demonstrate actual effectiveness (retrospective effectiveness) on an ongoing basis.

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The documentation of each hedging relationship sets out how the effectiveness of the hedge is assessed. The method an HSBC entity adopts for assessing hedge effectiveness will depend on its risk management strategy.

For prospective effectiveness, the hedging instrument must be expected to be highly effective in offsetting changes in fair value or cash flows attributable to the hedged risk during the period for which the hedge is designated. For actual effectiveness to be achieved, the changes in fair value or cash flows must offset each other in the range of 80 per cent to 125 per cent.

Hedge ineffectiveness is recognised in the income statement in Net trading income.

**Derivatives that do not qualify for hedge accounting**

All gains and losses from changes in the fair values of derivatives that do not qualify for hedge accounting are recognised immediately in the income statement. These gains and losses are reported in Net trading income, except where derivatives are managed in conjunction with financial instruments designated at fair value (other than derivatives managed in conjunction with debt securities issued by the Group), in which case gains and losses are reported in Net income from financial instruments designated at fair value. The interest on derivatives managed in conjunction with debt securities issued by the Group which are designated at fair value is recognised in Interest expense. All other gains and losses on these derivatives are reported in Net income from financial instruments designated at fair value.

(l) Derecognition of financial assets and liabilities

Financial assets are derecognised when the contractual right to receive cash flows from the assets has expired; or when HSBC has transferred its contractual right to receive the cash flows of the financial assets, and either:

- substantially all the risks and rewards of ownership have been transferred; or
- HSBC has neither retained nor transferred substantially all the risks and rewards, but has not retained control.

Financial liabilities are derecognised when they are extinguished, that is when the obligation is discharged, cancelled or expires.

(m) Offsetting financial assets and financial liabilities

Financial assets and financial liabilities are offset and the net amount reported in the balance sheet when there is a legally enforceable right to offset the recognised amounts and there is an intention to settle on a net basis, or realise the asset and settle the liability simultaneously.

(n) Subsidiaries, associates and joint ventures

HSBC classifies investments in entities which it controls as subsidiaries. Where HSBC is a party to a contractual arrangement whereby, together with one or more parties, it undertakes an economic activity that is subject to joint control, HSBC classifies its interest in the venture as a joint venture. HSBC classifies investments in entities over which it has significant influence, and that are neither subsidiaries nor joint ventures, as associates. For the purpose of determining this classification, control is considered to be the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.

HSBC Holdings investments in subsidiaries are stated at cost less any impairment losses. Reversals of impairment losses are recognised in the income statement if there has been a change in the estimates used to determine the recoverable amount of the investment.

Investments in associates and interests in joint ventures are recognised using the equity method. Under this method, such investments are initially stated at cost, including attributable goodwill, and are adjusted thereafter for the post-acquisition change in HSBCs share of net assets.

Profits on transactions between HSBC and its associates and joint ventures are eliminated to the extent of HSBC's interest in the respective associates or joint ventures. Losses are also eliminated to the extent of HSBC's interest in the associates or joint ventures unless the transaction provides evidence of an impairment of the asset transferred.

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HSBC HOLDINGS PLC

**Notes on the Financial Statements** (continued)**Note 2**

## (o) Goodwill and intangible assets

- (i) Goodwill arises on business combinations, including the acquisition of subsidiaries, and on the acquisition of interests in joint ventures and associates, when the cost of acquisition exceeds the fair value of HSBC's share of the identifiable assets, liabilities and contingent liabilities acquired. If HSBC's interest in the fair value of the identifiable assets, liabilities and contingent liabilities of an acquired business is greater than the cost of acquisition, the excess is recognised immediately in the income statement.

Intangible assets are recognised separately from goodwill when they are separable or arise from contractual or other legal rights, and their fair value can be measured reliably.

Goodwill is allocated to cash-generating units for the purpose of impairment testing, which is undertaken at the lowest level at which goodwill is monitored for internal management purposes. Impairment testing is performed at least annually, and whenever there is an indication that the cash-generating unit may be impaired, by comparing the present value of the expected future cash flows from a cash-generating unit with the carrying amount of its net assets, including attributable goodwill. Goodwill is stated at cost less accumulated impairment losses. Impairment losses are charged to the income statement.

Goodwill on acquisitions of interests in joint ventures and associates is included in "Interests in associates and joint ventures".

At the date of disposal of a business, attributable goodwill is included in HSBC's share of net assets in the calculation of the gain or loss on disposal.

- (ii) Intangible assets include the value of in-force long-term insurance business, computer software, trade names, mortgage servicing rights, customer lists, core deposit relationships, credit card customer relationships and merchant or other loan relationships. Intangible assets are subject to impairment review if there are events or changes in circumstances that indicate that the carrying amount may not be recoverable.
- Intangible assets that have an indefinite useful life, or are not yet ready for use, are tested for impairment annually. This impairment test may be performed at any time during the year, provided it is performed at the same time every year. An intangible asset recognised during the current period is tested before the end of the current year.
  - Intangible assets that have a finite useful life, except for the value of in-force long-term insurance business, are stated at cost less amortisation and accumulated impairment losses and are amortised over their estimated useful lives. Estimated useful life is the lower of legal duration and expected useful life. The amortisation of mortgage servicing rights is included within "Net fee income".

For the accounting policy governing the value of in-force long-term insurance business (see Note 2x).

- (iii) Intangible assets are amortised over their finite useful lives, generally on a straight line basis, as follows:

Trade names	10 years
Mortgage servicing rights	generally between 5 and 12 years

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Internally generated software	between 3 and 5 years
Purchased software	between 3 and 5 years
Customer/merchant relationships	between 3 and 10 years
Other	generally 10 years

(p) Property, plant and equipment

Land and buildings are stated at historical cost, or fair value at the date of transition to IFRSs (□deemed cost□), less any impairment losses and depreciation calculated to write off the assets over their estimated useful lives as follows:

- freehold land is not depreciated;
- freehold buildings are depreciated at the greater of two per cent per annum on a straight-line basis or over their remaining useful lives; and
- leasehold buildings are depreciated over the unexpired terms of the leases, or over their remaining useful lives.

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Equipment, fixtures and fittings (including equipment on operating leases where HSBC is the lessor) are stated at cost less any impairment losses and depreciation calculated on a straight-line basis to write off the assets over their useful lives, which run to a maximum of 35 years but are generally between 5 years and 20 years.

Property, plant and equipment is subject to an impairment review if there are events or changes in circumstances which indicate that the carrying amount may not be recoverable.

HSBC holds certain properties as investments to earn rentals or for capital appreciation, or both. Investment properties are included in the balance sheet at fair value with changes therein recognised in the income statement in the period of change. Fair values are determined by independent professional valuers who apply recognised valuation techniques.

(q) Finance and operating leases

Agreements which transfer to counterparties substantially all the risks and rewards incidental to the ownership of assets, but not necessarily legal title, are classified as finance leases. When HSBC is a lessor under finance leases the amounts due under the leases, after deduction of unearned charges, are included in [Loans and advances to banks] or [Loans and advances to customers] as appropriate. The finance income receivable is recognised in [Net interest income] over the periods of the leases so as to give a constant rate of return on the net investment in the leases.

When HSBC is a lessee under finance leases, the leased assets are capitalised and included in [Property, plant and equipment] and the corresponding liability to the lessor is included in [Other liabilities]. A finance lease and its corresponding liability are recognised initially at the fair value of the asset or, if lower, the present value of the minimum lease payments. Finance charges payable are recognised in [Net interest income] over the period of the lease based on the interest rate implicit in the lease so as to give a constant rate of interest on the remaining balance of the liability.

All other leases are classified as operating leases. When acting as lessor, HSBC includes the assets subject to operating leases in [Property, plant and equipment] and accounts for them accordingly. Impairment losses are recognised to the extent that residual values are not fully recoverable and the carrying value of the equipment is thereby impaired. When HSBC is the lessee, leased assets are not recognised on the balance sheet. Rentals payable and receivable under operating leases are accounted for on a straight-line basis over the periods of the leases and are included in [General and administrative expenses] and [Other operating income], respectively.

(r) Income tax

Income tax comprises current tax and deferred tax. Income tax is recognised in the income statement except to the extent that it relates to items recognised directly in equity, in which case it is recognised in equity.

Current tax is the tax expected to be payable on the taxable profit for the year, calculated using tax rates enacted or substantively enacted by the balance sheet date, and any adjustment to tax payable in respect of previous years. Current tax assets and liabilities are offset when HSBC intends to settle on a net basis and the legal right to offset exists.

Deferred tax is recognised on temporary differences between the carrying amounts of assets and liabilities in the balance sheet and the amounts attributed to such assets and liabilities for tax purposes. Deferred tax liabilities are generally recognised for all taxable temporary differences and deferred tax assets are recognised to the extent that it is probable that future taxable profits will be available against which deductible temporary differences can be utilised.

Deferred tax is calculated using the tax rates expected to apply in the periods in which the assets will be realised or the liabilities settled, based on tax rates and laws enacted, or substantively enacted, by the balance sheet date. Deferred tax assets and liabilities are offset when they arise in the same tax reporting group and relate to income taxes levied by the same taxation authority, and when a legal right to offset exists in the entity.

Deferred tax relating to actuarial gains and losses on post-employment benefits is recognised directly in equity. Deferred tax relating to fair value remeasurement of available-for-sale investments and cash flow hedging instruments which are charged or credited directly to equity, is also credited or charged directly to equity and is subsequently recognised in the income statement when the deferred fair value gain or loss is recognised in the income statement.

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HSBC HOLDINGS PLC

## Notes on the Financial Statements (continued)

### Note 2

#### (s) Pension and other post-employment benefits

HSBC operates a number of pension and other post-employment benefit plans throughout the world. These plans include both defined benefit and defined contribution plans and various other post-employment benefits such as post-employment health-care.

Payments to defined contribution plans and state-managed retirement benefit plans, where HSBC's obligations under the plans are equivalent to a defined contribution plan, are charged as an expense as they fall due.

The defined benefit pension costs and the present value of defined benefit obligations are calculated at the reporting date by the schemes' actuaries using the Projected Unit Credit Method. The net charge to the income statement mainly comprises the current service cost, plus the unwinding of the discount rate on plan liabilities, less the expected return on plan assets, and is presented in operating expenses. Past service costs are charged immediately to the income statement to the extent that the benefits have vested, and are otherwise recognised on a straight-line basis over the average period until the benefits vest. Actuarial gains and losses comprise experience adjustments (the effects of differences between the previous actuarial assumptions and what has actually occurred), as well as the effects of changes in actuarial assumptions. Actuarial gains and losses are recognised in 'Shareholders' equity' and presented in the Statement of Recognised Income and Expense in the period in which they arise.

The defined benefit liability recognised in the balance sheet represents the present value of defined benefit obligations adjusted for unrecognised past service costs and reduced by the fair value of plan assets. Any net defined benefit surplus is limited to unrecognised past service costs plus the present value of available refunds and reductions in future contributions to the plan.

The costs of obligations arising from other defined post-employment benefits plans, such as defined benefit health-care plans, are accounted for on the same basis as defined benefit pension plans.

#### (t) Share-based payments

The cost of share-based payment arrangements with employees is measured by reference to the fair value of equity instruments on the date they are granted, and recognised as an expense on a straight-line basis over the vesting period, with a corresponding credit to the 'Share-based payment reserve'. The fair value of equity instruments that are made available immediately, with no vesting period attached to the award, are expensed immediately.

Fair value is determined by using appropriate valuation models, taking into account the terms and conditions upon which the equity instruments were granted. Market performance conditions are reflected as an adjustment to the fair value of equity instruments at the date of grant, so that an award is treated as vesting irrespective of whether the market performance condition is satisfied, provided all other conditions are satisfied.

Vesting conditions, other than market performance conditions, are not factored into the initial estimate of the fair value at the grant date. They are taken into account by adjusting the number of equity instruments included in the measurement of the transaction, so that the amount recognised for services received as consideration for the equity instruments granted shall be based on the number of equity instruments that eventually vest. On a cumulative basis, no expense is recognised for equity instruments that do not vest because of a failure to satisfy non-market performance or service conditions.

Where an award has been modified, as a minimum the expense of the original award continues to be recognised as if it had not been modified. Where the effect of a modification is to increase the fair value of



an award or increase the number of equity instruments, the incremental fair value of the award or incremental fair value of the extra equity instruments is recognised in addition to the expense of the original grant, measured at the date of modification, over the remaining vesting period.

A cancellation that occurs during the vesting period is treated as an acceleration of vesting, and recognised immediately for the amount that would otherwise have been recognised for services over the vesting period.

Where HSBC Holdings enters into share-based payment arrangements involving employees of subsidiaries, the cost is recognised in [Investment in subsidiaries] and credited to the [Share-based payment reserve] over the vesting period. Where the cost is recharged to the subsidiary, it is recognised as an inter-company debtor, not as an investment in subsidiary. Where a subsidiary has funded the share-based payment arrangement, [Investment

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in subsidiaries is reduced upon exercise by the number of equity instruments exercised multiplied by their grant date fair value.

(u) Foreign currencies

Items included in the financial statements of each of HSBC's entities are measured using the currency of the primary economic environment in which the entity operates (the functional currency). The consolidated financial statements of HSBC are presented in US dollars, which is the Group's presentation currency.

Transactions in foreign currencies are recorded in the functional currency at the rate of exchange prevailing on the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are translated into the functional currency at the rate of exchange ruling at the balance sheet date. Any resulting exchange differences are included in the income statement. Non-monetary assets and liabilities that are measured at historical cost in a foreign currency are translated into the functional currency using the rate of exchange at the date of the initial transaction. Non-monetary assets and liabilities measured at fair value in a foreign currency are translated into the functional currency using the rate of exchange at the date the fair value was determined. Any exchange component of a gain or loss on a non-monetary item is recognised directly in equity if the gain or loss on the non-monetary item is recognised directly in equity. Any exchange component of a gain or loss on a non-monetary item is recognised directly in the income statement if the gain or loss on the non-monetary item is recognised in the income statement.

In the consolidated financial statements, the assets, including related goodwill where applicable, and liabilities of branches, subsidiaries, joint ventures and associates whose functional currency is not US dollars, are translated into the Group's presentation currency at the rate of exchange ruling at the balance sheet date. The results of branches, subsidiaries, joint ventures and associates whose functional currency is not US dollars are translated into US dollars at the average rates of exchange for the reporting period. Exchange differences arising from the retranslation of opening foreign currency net investments, and exchange differences arising from retranslation of the result for the reporting period from the average rate to the exchange rate prevailing at the period end, are recognised in equity in the Foreign exchange reserve. Exchange differences on a monetary item that is part of a net investment in a foreign operation are recognised in the income statement of the separate financial statements. In consolidated financial statements these exchange differences are recognised in the Foreign exchange reserve in shareholders' equity. On disposal of a foreign operation, exchange differences relating thereto and previously recognised in reserves are recognised in the income statement.

(v) Provisions

Provisions are recognised when it is probable that an outflow of economic benefits will be required to settle a current legal or constructive obligation as a result of past events, and a reliable estimate can be made of the amount of the obligation.

Contingent liabilities, which include certain guarantees and letters of credit pledged as collateral security, are possible obligations that arise from past events whose existence will be confirmed only by the occurrence, or non-occurrence, of one or more uncertain future events not wholly within the control of HSBC. Contingent liabilities are not recognised in the financial statements but are disclosed unless the probability of settlement is remote.

(w) Financial guarantee contracts

Liabilities under financial guarantees contracts which are not classified as insurance contracts, are recorded initially at their fair value, which is generally the fee received or receivable. Subsequently, financial guarantee liabilities are measured at the higher of the initial fair value, less cumulative amortisation, and the best estimate of the expenditure required to settle the obligations.

HSBC Holdings has issued financial guarantees to other Group entities. Where it has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, HSBC may elect to account for guarantees as an insurance contract. This election is made on a contract by contract basis, but the election for each contract is irrevocable. Where these

guarantees have been classified as insurance contracts, they are measured and recognised as insurance liabilities.

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HSBC HOLDINGS PLC

**Notes on the Financial Statements** (continued)**Note 2****(x) Insurance contracts**

Through its insurance subsidiaries, HSBC issues contracts to customers that contain insurance risk, financial risk or a combination thereof. A contract under which HSBC accepts significant insurance risk from another party by agreeing to compensate that party on the occurrence of a specified uncertain future event, is classified as an insurance contract. An insurance contract may also transfer financial risk, but is accounted for as an insurance contract if the insurance risk is significant.

While investment contracts with discretionary participation features are financial instruments, they continue to be treated as insurance contracts as permitted by IFRS 4.

Insurance contracts are accounted for as follows:

**Premiums**

Gross insurance premiums for non-life insurance business are reported as income over the term of the insurance contracts based on the proportion of risks borne during the accounting period. The unearned premium (the proportion of the business underwritten in the accounting year relating to the period of risk after the balance sheet date) is calculated on a daily or monthly pro rata basis.

Premiums for life insurance contracts are accounted for when receivable, except in unit-linked insurance contracts where premiums are accounted for when liabilities are established.

Reinsurance premiums are accounted for in the same accounting period as the premiums for the direct insurance contracts to which they relate.

**Claims and reinsurance recoveries**

Gross insurance claims for non-life insurance contracts include paid claims and movements in outstanding claims liabilities.

Gross insurance claims for life insurance contracts reflect the total cost of claims arising during the year, including claim handling costs and any policyholder bonuses allocated in anticipation of a bonus declaration. Claims arising during the year include maturities, surrenders and death claims.

Maturity claims are recognised when due for payment. Surrenders are recognised when paid or at an earlier date on which, following notification, the policy ceases to be included within the calculation of the related insurance liabilities. Death claims are recognised when notified.

Reinsurance recoveries are accounted for in the same period as the related claim.

**Liabilities under insurance contracts**

Outstanding claims liabilities for non-life insurance contracts are based on the estimated ultimate cost of all claims incurred but not settled at the balance sheet date, whether reported or not, together with related claim-handling costs and a reduction for the expected value of salvage and other recoveries. Liabilities for claims incurred but not reported are made on an estimated basis, using appropriate statistical techniques.

Liabilities under non-linked life insurance contracts are calculated by each life insurance operation based on local actuarial principles.

Liabilities under unit-linked life insurance contracts are at least equivalent to the surrender or transfer value which is calculated by reference to the value of the relevant underlying funds or indices.

A liability adequacy test is carried out on insurance liabilities to ensure that the carrying amount of the liabilities is sufficient in the light of current estimates of future cash flows. When performing the liability adequacy test, all contractual cash flows are discounted and compared with the carrying value of the liability. When a shortfall is identified it is charged immediately to the income statement.

**Present value of in-force long-term insurance business**

The value placed on insurance contracts that are classified as long-term insurance business and are in force at the balance sheet date is recognised as an asset.

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The PVIF long-term insurance business is determined by discounting future cash flows expected to emerge from business currently in force using appropriate assumptions in assessing factors such as future mortality, lapse rates and levels of expenses and a risk discount rate that reflects the risk premium attributable to the respective long-term insurance business. Movements in the PVIF long-term insurance business are included in [Other operating income] on a gross of tax basis.

### **Future profit participation**

Where contracts provide discretionary profit participation benefits to policyholders, insurance liabilities include the net unrealised gains recognised in connection with the assets backing the contracts to the extent that policyholders will benefit from such gains. This benefit may arise from the contractual terms, regulation, or past distribution policy. The corresponding movement in liability is recognised in equity or in the income statement in the same proportion to the net unrealised gains on the assets. In the case of net unrealised losses, a deferred participating asset is recognised only to the extent that its recoverability is highly probable.

#### **(y) Investment contracts**

Customer liabilities under linked and certain non-linked investment contracts and the corresponding financial assets are designated at fair value. Movements in fair value are recognised in [Net income from financial investments designated at fair value]. Premiums receivable and amounts withdrawn are accounted for as increases or decreases in the liability recorded in respect of investment contracts.

Liabilities under linked investment contracts are at least equivalent to the surrender or transfer value which is calculated by reference to the value of the relevant underlying funds or indices.

Investment management fees receivable are recognised in the income statement over the period of the provision of the investment management services, in [Net fee income].

The incremental costs directly related to the acquisition of new investment contracts or renewing existing investment contracts are deferred and amortised over the period during which the investment management services are provided.

#### **(z) Debt securities issued and deposits by customers and banks**

Financial liabilities are recognised when HSBC enters into the contractual provisions of the arrangements with counterparties, which is generally on trade date, and initially measured at fair value, which is normally the consideration received net of directly attributable transaction costs incurred. Subsequent measurement of financial liabilities, other than those measured at fair value through profit or loss and financial guarantees, is at amortised cost, using the effective interest rate method to amortise the difference between proceeds net of directly attributable transaction costs and the redemption amount over the expected life of the debt.

#### **(aa) Share capital**

Shares are classified as equity when there is no contractual obligation to transfer cash or other financial assets. Incremental costs directly attributable to the issue of equity instruments are shown in equity as a deduction from the proceeds, net of tax.

HSBC Holdings plc shares held by HSBC are recognised in [Total shareholders] equity] as a deduction from retained earnings until they are cancelled. When such shares are subsequently sold, reissued or otherwise disposed of, any consideration received is included in [Total shareholders] equity], net of any directly attributable incremental transaction costs and related income tax effects.

#### **(ab) Cash and cash equivalents**

For the purpose of the cash flow statement, cash and cash equivalents include highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of change in value. Such investments are normally those with less than three months] maturity from the date of acquisition, and include cash and balances at central banks, treasury bills and other eligible bills,

loans and advances to banks, items in the course of collection from or in transmission to other banks, and certificates of deposit.

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**Notes on the Financial Statements** (continued)

Notes 3, 4 and 5

**3 Net income from financial instruments designated at fair value**

Net income from financial instruments designated at fair value includes:

- all gains and losses from changes in the fair value of financial assets and liabilities designated at fair value, including liabilities under investment contracts;
- all gains and losses from changes in the fair value of derivatives that are managed in conjunction with financial assets and liabilities designated at fair value; and
- interest income, interest expense and dividend income in respect of:
  - financial assets and liabilities designated at fair value; and
  - derivatives managed in conjunction with the above,

except for interest arising on HSBC's issued debt securities, together with the interest element of derivatives managed in conjunction with them, which are recognised in □Interest expense□.

	<b>2007</b>	2006	2005
	<b>US\$m</b>	US\$m	US\$m
Net income/(expense) arising on:			
□ financial assets held to meet liabilities under insurance and investment contracts	<b>2,056</b>	1,552	1,760
□ other financial assets designated at fair value	<b>581</b>	217	90
□ derivatives managed in conjunction with financial assets designated at fair value	<b>(18)</b>	57	17
	<b>2,619</b>	1,826	1,867
□ liabilities to customers under investment contracts	<b>(940)</b>	(1,008)	(1,126)
□ HSBC's issued debt securities	<b>336</b>	(277)	1,795
□ derivatives managed in conjunction with HSBC's issued debt securities	<b>2,476</b>	242	(1,392)
□ other financial liabilities designated at fair value	<b>(395)</b>	(125)	(112)
□ derivatives managed in conjunction with other financial liabilities designated at fair value	<b>(13)</b>	(1)	2
	<b>1,464</b>	(1,169)	(833)
Net income from financial instruments designated at fair value	<b>4,083</b>	657	1,034

- 1 Gains and losses from changes in the fair value of HSBC's issued debt securities may arise from changes in HSBC's own credit spread. In 2007 HSBC recognised a US\$3,055 million gain on changes in the fair value of these instruments arising from changes in HSBC's own credit spread (2006: loss US\$388 million).



**4 Gains from dilution of interests in associates**

During 2007, certain HSBC associates issued new shares. HSBC did not subscribe for any of the shares issued under these offers and, as a result, its interests in the associates' equity decreased. The assets of each associate substantially increased as a result of the new share issues and, as a consequence, the transactions resulted in an increase in HSBC's share of the associates' underlying net assets, notwithstanding the reduction in the Group's proportionate ownership interests. This increase represents gains from dilution of the Group's interests in the associates, and is presented in the income statement.

Year ended 31 December 2007

<b>Associates</b>	<b>Gains arising from dilution of HSBC's interests US\$m</b>	<b>HSBC's interests after issue of new shares %</b>	<b>HSBC's interests before issue of new shares %</b>
Industrial Bank <sup>1</sup>	<b>187</b>	<b>12.78</b>	15.98
Ping An Insurance	<b>485</b>	<b>16.78</b>	19.90
Bank of Communications <sup>2</sup>	<b>404</b>	<b>18.60</b>	19.90
Financiera Independencia S.A. de C.V.	<b>11</b>	<b>18.68</b>	19.90
Vietnam Technological and Commercial Joint Stock Bank	<b>5</b>	<b>14.44</b>	15.00
<b>Gains arising from dilution of interests in associates</b>	<b>1,092</b>		

1 Investment held through Hang Seng Bank, a 62.14 per cent owned subsidiary of HSBC. The dilution gains therefore include a minority interest of US\$71 million.

2 Subsequent to the dilution of its interests in Bank of Communications, HSBC increased its holding from 18.60 per cent to 19.01 per cent at 31 December 2007 (Note 21).

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The dilution does not affect the classification of the Group's investments as "Investments in associates" as the Group continues to retain significant influence (see Note 21).

## 5 Net earned insurance premiums

	Non-life insurance US\$m	Life insurance (non-linked) US\$m	Life insurance (linked) US\$m	Investment contracts with discretionary participation features US\$m	Total US\$m
<b>2007</b>					
Gross written premiums	1,853	4,892	2,350	1,890	10,985
Movement in unearned premiums	2	14	□	□	16
Gross earned premiums	1,855	4,906	2,350	1,890	11,001
Gross written premiums ceded to reinsurers	(385)	(357)	(1,166)	□	(1,908)
Reinsurers' share of movement in unearned premiums	(22)	□	5	□	(17)
Reinsurers' share of gross earned premiums	(407)	(357)	(1,161)	□	(1,925)
Net earned insurance premiums	1,448	4,549	1,189	1,890	9,076
<b>2006</b>					
Gross written premiums	1,824	3,640	848	8	6,320
Movement in unearned premiums	122	14	(1)	□	135
Gross earned premiums	1,946	3,654	847	8	6,455
Gross written premiums ceded to reinsurers	(451)	(274)	(14)	□	(739)
Reinsurers' share of movement in unearned premiums	(48)	□	□	□	(48)
Reinsurers' share of gross earned premiums	(499)	(274)	(14)	□	(787)
Net earned insurance premiums	1,447	3,380	833	8	5,668
<b>2005</b>					
Gross written premiums	2,364	3,441	768	12	6,585
Movement in unearned premiums	(225)	2	(210)	□	(433)
Gross earned premiums	2,139	3,443	558	12	6,152
Gross written premiums ceded to reinsurers	(479)	(277)	(20)	□	(776)
	60	□	□	□	60

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Reinsurers' share of movement in  
unearned premiums

Reinsurers' share of gross earned premiums	(419)	(277)	(20)	□	(716)
Net earned insurance premiums	1,720	3,166	538	12	5,436

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**Notes on the Financial Statements** (continued)

Notes 6, 7 and 8

**6 Net insurance claims incurred and movement in liabilities to policyholders**

	Non-life insurance US\$m	Life insurance (non-linked) US\$m	Life insurance (linked) US\$m	Investment contracts with discretionary participation features US\$m	Total US\$m
<b>2007</b>					
Claims, benefits and surrenders paid	1,017	940	790	1,080	3,827
Movement in liabilities	82	2,437	2,096	1,108	5,723
Gross claims incurred and movement in liabilities	1,099	3,377	2,886	2,188	9,550
Reinsurers' share of claims, benefits and surrenders paid	(207)	(169)	(45)	□	(421)
Reinsurers' share of movement in liabilities	36	518	(1,075)	□	(521)
Reinsurers' share of claims incurred and movement in liabilities	(171)	349	(1,120)	□	(942)
<b>Net insurance claims incurred and movement in liabilities to policyholders</b>	<b>928</b>	<b>3,726</b>	<b>1,766</b>	<b>2,188</b>	<b>8,608</b>
<b>2006</b>					
Claims, benefits and surrenders paid	889	814	495	□	2,198
Movement in liabilities	10	2,207	651	6	2,874
Gross claims incurred and movement in liabilities	899	3,021	1,146	6	5,072
Reinsurers' share of claims, benefits and surrenders paid	(228)	(154)	(9)	□	(391)
Reinsurers' share of movement in liabilities	57	(54)	20	□	23
Reinsurers' share of claims incurred and movement in liabilities	(171)	(208)	11	□	(368)
<b>Net insurance claims incurred and movement in</b>	<b>728</b>	<b>2,813</b>	<b>1,157</b>	<b>6</b>	<b>4,704</b>

liabilities to policyholders					
2005					
Claims, benefits and surrenders paid	966	621	357	□	1,944
Movement in liabilities	72	1,683	445	9	2,209
Gross claims incurred and movement in liabilities	1,038	2,304	802	9	4,153
Reinsurers' share of claims, benefits and surrenders paid	(146)	(111)	(11)	□	(268)
Reinsurers' share of movement in liabilities	2	191	(11)	□	182
Reinsurers' share of claims incurred and movement in liabilities	(144)	80	(22)	□	(86)
Net insurance claims incurred and movement in liabilities to policyholders	894	2,384	780	9	4,067

[Back to Contents](#)**7 Net operating income**

Net operating income is stated after the following items of income, expense, gains and losses:

	<b>2007</b>	2006	2005
	<b>US\$m</b>	US\$m	US\$m
<b>Income</b>			
Interest recognised on impaired financial assets	<b>404</b>	284	120
Fees earned on financial assets or liabilities not held for trading nor designated at fair value, other than fees included in effective interest rate calculations on these types of assets and liabilities	<b>15,140</b>	11,182	9,077
Fees earned on trust and other fiduciary activities where HSBC holds or invests assets on behalf of its customers	<b>3,695</b>	2,909	2,912
Income from listed investments	<b>10,944</b>	7,304	6,819
Income from unlisted investments	<b>10,429</b>	9,192	5,001
<b>Expense</b>			
Interest on financial instruments, excluding interest on financial liabilities held for trading or designated at fair value	<b>(50,876)</b>	(38,158)	(26,627)
Fees payable on financial assets or liabilities not held for trading nor designated at fair value, other than fees included in effective interest rate calculations on these types of assets and liabilities	<b>(1,923)</b>	(1,826)	(1,357)
Fees payable relating to trust and other fiduciary activities where HSBC holds or invests assets on behalf of its customers	<b>(163)</b>	(103)	(238)
<b>Gains/(losses)</b>			
Gain/(loss) on disposal or settlement of loans and advances	<b>64</b>	24	(12)
Net impairment loss on loans and advances	<b>(17,177)</b>	(10,547)	(7,860)
Net (charge)/reversal of impairment allowances in respect of available-for-sale financial investments	<b>(86)</b>	(21)	42
Gains on disposal of property, plant and equipment, intangible assets and non-financial investments	<b>213</b>	781	703

**8 Employee compensation and benefits**

	<b>2007</b>	2006	2005
	<b>US\$m</b>	US\$m	US\$m
Wages and salaries	<b>18,535</b>	16,186	14,008
Social security costs	<b>1,587</b>	1,194	1,072
Post-employment benefits	<b>1,212</b>	1,120	1,065
	<b>21,334</b>	18,500	16,145

The average number of persons employed by HSBC during the year was as follows:

	<b>2007</b>	2006	2005
Europe	<b>86,918</b>	84,170	82,638
Hong Kong	<b>27,702</b>	27,328	25,699

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Rest of Asia-Pacific	<b>83,103</b>	68,182	50,605
North America	<b>58,117</b>	57,654	51,518
Latin America	<b>66,442</b>	58,863	54,825
	<u>          </u>	<u>          </u>	<u>          </u>
Total	<b>322,282</b>	296,197	265,285
	<u>          </u>	<u>          </u>	<u>          </u>

Post-employment  
benefit plans

**Income statement  
charge**

	<b>2007 US\$m</b>	2006 US\$m	2005 US\$m
Defined benefit pension plans	<b>694</b>	602	618
□ HSBC Bank (UK) Pension Scheme	<b>490</b>	342	410
□ Other plans	<b>204</b>	260	208
Defined contribution plans	<b>485</b>	456	389
	<u>          </u>	<u>          </u>	<u>          </u>
	<b>1,179</b>	1,058	1,007
Defined benefit healthcare plans	<b>33</b>	62	58
	<u>          </u>	<u>          </u>	<u>          </u>
	<b>1,212</b>	1,120	1,065
	<u>          </u>	<u>          </u>	<u>          </u>

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HSBC HOLDINGS PLC

**Notes on the Financial Statements** (continued)*Note 8***Net liabilities recognised on balance sheet in respect of defined benefit plans**

	2007 US\$m	2006 US\$m
Defined benefit pension plans	<b>1,968</b>	4,553
□ HSBC Bank (UK) Pension Scheme	<b>808</b>	3,745
□ Other plans	<b>1,160</b>	808
Defined benefit healthcare plan	<b>925</b>	1,002
	<b>2,893</b>	5,555

**HSBC pension plans**

HSBC operates some 196 pension plans throughout the world, covering 86 per cent of HSBC's employees, with a total pension cost of US\$1,179 million (2006: US\$1,058 million; 2005: US\$1,007 million), of which US\$626 million (2006: US\$668 million; 2005: US\$546 million) relates to plans outside the UK.

Progressively, HSBC has been moving to defined contribution plans for all new employees. The pension cost for defined contribution plans, which cover 49 per cent of HSBC's employees, was US\$485 million (2006: US\$456 million; 2005: US\$389 million).

Both HSBC's and, where relevant and appropriate, the trustees' long-term investment objectives for defined benefit plans are:

- to limit the risk of the assets failing to meet the liability of the plans over the long-term; and
- to maximise returns consistent with an acceptable level of risk so as to control the long-term costs of the defined benefit plans.

Both HSBC and, where relevant and appropriate, the trustees, consider that the investment policy should be consistent with meeting their mutual overall long-term investment objectives. In pursuit of these long-term objectives, a benchmark is established for the allocation of the defined benefit plan assets between asset classes. In addition, each permitted asset class has its own benchmarks, such as stock market or property valuation indices and desired levels of out-performance where relevant. This is intended to be reviewed at least triennially within 18 months of the date at which the actuarial valuation is made, or more frequently if circumstances or local legislation so require. The process generally involves an extensive asset and liability review.

The Group's defined benefit plans, which cover 37 per cent of HSBC's employees, are predominantly funded plans with assets which, in the case of most of the larger plans, are held in trust or similar funds separate from HSBC. The plans are reviewed at least annually or in accordance with local practice and regulations by qualified actuaries. The actuarial assumptions used to calculate the defined benefit obligations and related current service costs vary according to the economic conditions of the countries in which they are situated.

The largest plan exists in the UK, where the HSBC Bank (UK) Pension Scheme covers employees of HSBC Bank plc and certain other employees of HSBC. This plan comprises a funded defined benefit plan (the principal plan) which is closed to new entrants, and a defined contribution plan which was established on 1 July 1996 for new employees.

The principal plan holds a diversified portfolio of investments to meet future cash flow liabilities arising from accrued benefits as they fall due to be paid. The Trustee of the principal plan is required to produce a written



Statement of Investment Principles (SIP). The SIP sets out the principles governing how decisions about investments are made.

In 2006, HSBC and the Trustee of the principal plan agreed to change the investment strategy in order to reduce the investment risk. This involved switching from a largely equity-based strategy to a strategy largely based on holding bonds together with a more diverse range of investments. The principal plan committed to undertake a programme including entering into swap arrangements whereby the principal plan is committed to making LIBOR related interest payments in exchange for cash flows paid into the plan, based on a projection of the future benefit payments from the principal plan. The asset allocation for this strategy is:

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	%
Equities	15.0
Bonds	50.0
Alternative assets <sup>1</sup>	10.0
Property	10.0
Cash	15.0
	<hr style="width: 100px; margin: 0 auto;"/> 100.0 <hr style="width: 100px; margin: 0 auto;"/>

1 *Alternative assets include emerging market bonds, loans, and infrastructure assets .*

At 31 December 2007, this strategy was substantially in place and details of the swap arrangements are included in Note 44.

The latest actuarial investigation of the principal plan was made at 31 December 2005, by C G Singer, Fellow of the Institute of Actuaries, of Watson Wyatt Limited. At that date, the market value of the HSBC Bank (UK) Pension Scheme's assets was US\$18,072 million (including assets relating to the defined benefit plan, the defined contribution plan, and additional voluntary contributions). The market value of the plan assets represented 89 per cent of the amount expected to be required, on the basis of the assumptions adopted, to provide the benefits accrued to members after allowing for expected future increases in earnings, and the resulting deficit amounted to US\$2,065 million. The method adopted for this investigation was the projected unit method. The expected cash flows from the plan were projected by reference to the Retail Price Index (RPI) swap break-even curve at 31 December 2005. Salary increases were assumed to be 1 per cent per annum above RPI and inflationary pension increases, subject to a minimum of 0 per cent and a maximum of 5 per cent, were assumed to be in line with RPI. The projected cash flows were discounted at the LIBOR swap curve at 31 December 2005 plus a margin for the expected return on the investment strategy of 110 basis points per annum. The mortality experience of the plan's pensioners over the three year period since the previous valuation was analysed and the mortality assumption set on the basis of this with allowances for medium cohort improvements on the PA92 series of tables from the valuation date.

In anticipation of the results of the 2005 investigation, on 22 December 2005 HSBC Bank plc made an additional contribution of US\$1,746 million to the principal plan in order to reduce the deficit of the plan. Following receipt of the valuation results, HSBC agreed with the Trustee to meet a schedule of additional future funding payments, as set out below:

	US\$m <sub>1</sub>	£m
2007	587	300
2012	933	465
2013	933	465
2014	933	465

1 *The payment schedule has been agreed with the Trustee in pounds sterling and the equivalent US dollar amounts are shown at the exchange rate effective as at 31 December 2007, or as at the date of payment in respect of the contribution made during the period.*

HSBC considers that the contributions set out above are sufficient to meet the deficit as at 31 December 2005 over the agreed period. HSBC Bank plc made the contribution of US\$587 million in March 2007

HSBC also decided to make ongoing contributions to the principal plan in respect of the accrual of benefits of defined benefit section members at the rate of 36 per cent of pensionable salaries from 1 January 2007, until the completion of the next actuarial valuation, due at 31 December 2008. During 2006 HSBC paid contributions at the rate of 20 per cent of pensionable salaries. A further 2 per cent of pensionable salaries is being paid over the period 1 January 2007 to 31 December 2014 to make good the difference in contributions during 2006.

As part of the 31 December 2005 valuation, calculations were also carried out as to the amount of assets that might be needed to meet the liabilities if the plan was discontinued and the members' benefits bought out with

an insurance company (although in practice this may not be possible for a plan of this size) or the Trustee continued to run the plan without the support of HSBC. The amount required under this approach is estimated to be US\$26,700 million as at 31 December 2005. In estimating the solvency position for this purpose, a more prudent assumption about future mortality was made than for the assessment of the ongoing position and it was assumed that the Trustee would alter the investment strategy to be an appropriately matched portfolio of cash and interest and inflation swaps. An explicit allowance for expenses was also included.

The benefits payable from the defined benefit plan are expected to be as shown in the chart below:

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HSBC HOLDINGS PLC

**Notes on the Financial Statements** (continued)**Note 8**

In Hong Kong, the HSBC Group Hong Kong Local Staff Retirement Benefit Scheme covers employees of The Hongkong and Shanghai Banking Corporation and certain other employees of HSBC Group. The scheme comprises a funded defined benefit scheme (which provides a lump sum on retirement but is now closed to new members) and a defined contribution scheme. The latter was established on 1 January 1999 for new employees. The latest valuation of the defined benefit plan was made at 31 December 2006 and was performed by Estella Chiu, Fellow of the Society of Actuaries of the United States of America, of HSBC Life (International) Limited, a subsidiary of HSBC Holdings. At the valuation date, the market value of the defined benefit scheme's assets was US\$1,109 million. On an ongoing basis, the actuarial value of the scheme's assets represented 119 per cent of the actuarial present value of the benefits accrued to members, after allowing for expected future increases in salaries, and the resulting surplus amounted to US\$174 million. On a wind-up basis, the scheme's assets represented 126 per cent of the members' vested benefits, based on current salaries, and the resulting surplus amounted to US\$228 million. The attained age method has been adopted for the valuation and the major assumptions used in this valuation were a discount rate of 4 per cent per annum and long-term salary increases of 3 per cent per annum (with short-term deviation from 2007 to 2008).

The HSBC North America (U.S.) Retirement Income Plan was formed with effect from the close of business on 31 December 2004 by the merger of the HSBC Bank USA Pension Plan and the Household International Retirement Income Plan. This plan covers employees of HSBC Bank USA, HSBC Finance, and certain other employees of HSBC USA. It comprises a final average pay plan (now closed to new participants) and a cash balance plan. All new employees participate in the cash balance plan. The most recent actuarial valuation of the plan was made at 1 January 2007 by Pedro Nebres, Fellow of the Society of Actuaries and John P. Ennenbach, Enrolled Actuary, of Mercer. Both are members of the American Academy of Actuaries. At that date, the market value of the merged plan's assets was US\$2,577 million and the actuarial value of assets was US\$2,504 million. The actuarial value of the assets represented 119 per cent of the benefits accrued to members, after allowing for expected future increases in earnings. The resulting surplus amounted to US\$407 million. The method employed for this valuation was the projected unit credit method and the main assumptions used were a discount rate of 8 per cent per annum and average salary increases of 3.75 per cent per annum.

The HSBC Bank (UK) Pension Scheme, The HSBC Group Hong Kong Local Staff Retirement Benefit Scheme, and the HSBC North America (U.S.) Retirement Income Plan cover 33 per cent of HSBC's employees.

**HSBC healthcare benefits plans**

HSBC also provides post-employment healthcare benefits under plans in the UK, the US, Canada, Mexico, France and Brazil, the majority of which are unfunded. Post-employment healthcare benefits plans are accounted for in the same manner as defined benefit pension plans. The plans are reviewed at least annually or in accordance with local practice and regulations by qualified actuaries. The actuarial assumptions used to calculate the defined benefit obligation and related current service cost vary according to the economic conditions of the countries in which they are situated. Total healthcare cost was US\$33 million (2006: US\$62 million; 2005: US\$58 million).

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Post-employment defined benefit plans<sup>1</sup> principal actuarial financial assumptions

The principal actuarial financial assumptions used to calculate the Group's obligations under its defined benefit pension and post-employment healthcare plans at 31 December 2007, were as follows. These assumptions will also form the basis for measuring periodic costs under the plans in 2008:

	Discount rate %	Inflation rate %	Rate of increase for pensions <sup>1</sup> %	Rate of pay increase %	Healthcare cost trend		
					Initial rate %	Ultimate rate %	Year of ultimate rate
UK	5.8	3.3	3.3	4.3	7.3	7.3	n/a
Hong Kong	3.45	n/a	n/a	5.02	n/a	n/a	n/a
US	6.55	2.5	n/a	3.75	9.6	5.0	2014
Jersey	5.8	3.3	3.3	5.05	n/a	n/a	n/a
Mexico	7.88	3.5	2.0	4.5	6.0	6.0	n/a
Brazil	10.75	4.5	4.5	4.5	10.5	5.5	2017
France	5.5	2.0	2.0	3.0	6.0	6.0	n/a
Canada	5.43	2.5	n/a	3.86	9.0	4.9	2012
Switzerland	3.3	1.5	n/a	2.38	n/a	n/a	n/a
Germany	5.5	2.0	2.0	3.0	n/a	n/a	n/a

<sup>1</sup> Rate of increase for pensions in payment and deferred pension.

The principal actuarial financial assumptions used to calculate the Group's obligations under its defined benefit pension and post-employment healthcare plans at 31 December 2006, were as follows. These assumptions also formed the basis for measuring periodic costs under the plans in 2007:

	Discount rate %	Inflation rate %	Rate of increase for pensions <sup>1</sup> %	Rate of pay increase %	Healthcare cost trend		
					Initial rate %	Ultimate rate %	Year of ultimate rate
UK	5.1	3.0	3.0	4.0	7.0	7.0	n/a
Hong Kong	3.75	n/a	n/a	3.0	n/a	n/a	n/a
US	5.9	2.5	n/a	3.75	10.5	5.0	2014
Jersey	5.1	3.0	3.0	4.75	n/a	n/a	n/a
Mexico	8.0	3.5	2.0	4.0	6.75	6.75	n/a
Brazil	10.75	4.5	4.5	4.5	11.0	5.5	2016
France	4.5	2.0	2.0	3.0	6.0	6.0	n/a
Canada	5.19	2.5	n/a	3.47	9.9	4.9	2012
Switzerland	2.25	1.5	n/a	2.25	n/a	n/a	n/a
Germany	4.5	2.0	2.0	3.0	n/a	n/a	n/a

1 *Rate of increase for pensions in payment and deferred pension.*

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HSBC HOLDINGS PLC

**Notes on the Financial Statements** (continued)**Note 8**

The principal actuarial financial assumptions used to calculate the Group's obligations under its defined benefit pension and post-employment healthcare plans at 31 December 2005, were as follows. These assumptions also formed the basis for measuring periodic costs under the plans in 2006:

	Discount rate %	Inflation rate %	Rate of increase for pensions <sup>1</sup> %	Rate of pay increase %	Healthcare cost trend		
					Initial rate %	Ultimate rate %	Year of ultimate rate
UK	4.75	2.7	2.7	3.7 <sub>2</sub>	6.7	6.7	n/a
Hong Kong	4.2	n/a	n/a	5.0	n/a	n/a	n/a
US	5.7	2.5	n/a	3.75	10.4	5.0	2013
Jersey	4.75	2.7	2.7	4.45	n/a	n/a	n/a
Mexico	8.90	3.75	3.75	4.5	7.3	7.3	n/a
Brazil	11.75	5.5	5.5	5.5	12.5	6.5	2016
France	4.1	2.0	2.0	3.0	6.0	6.0	n/a
Canada	5.25	2.5	n/a	3.0	7.3	4.5	2009
Switzerland	2.25	1.5	n/a	2.25	n/a	n/a	n/a
Germany	4.0	2.0	2.0	3.0	n/a	n/a	n/a

1 Rate of increase for pensions in payment and deferred pension.

2 The 2005 rate of pay increase assumptions disclosed have been increased from 3.2 per cent to 3.7 per cent to reflect an age-related promotional salary scale that was included in the obligation calculation but not in the disclosed assumption.

HSBC determines the discount rates to be applied to its obligations in consultation with the plans' local actuaries, on the basis of current average yields of high quality (AA rated or equivalent) debt instruments, with maturities consistent with those of the defined benefit obligations. The expected return on plan assets represents the best estimate of long-term future asset returns, which takes into account historical market returns plus additional factors such as the current rate of inflation and interest rates.

Mortality assumptions are increasingly significant in measuring the Group's obligations under its defined benefit pension and post-employment healthcare plans, particularly given the maturity of the plans. The mortality tables and average life expectancy at 65 used at 31 December 2007 were as follows:

Mortality table	Life expectancy at age 65 for a male member currently:		Life expectancy at age 65 for a female member currently:	
	Aged 65	Aged 45	Aged 65	Aged 45

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UK	PA92 <sup>1</sup>	<b>20.4</b>	<b>21.7</b>	<b>23.4</b>	<b>24.6</b>
Hong Kong	n/a	<b>n/a</b>	<b>n/a</b>	<b>n/a</b>	<b>n/a</b>
US	RP 2000 fully generational	<b>19.1</b>	<b>20.6</b>	<b>21.1</b>	<b>22.0</b>
Jersey	PA92 <sup>2</sup>	<b>21.9</b>	<b>23.0</b>	<b>24.8</b>	<b>25.8</b>
Mexico	EMSSA-97	<b>16.5</b>	<b>16.5</b>	<b>19.9</b>	<b>19.9</b>
Brazil	RP 2000 fully generational	<b>19.1</b>	<b>20.6</b>	<b>21.1</b>	<b>22.0</b>
France	TG 05	<b>22.9</b>	<b>25.7</b>	<b>26.4</b>	<b>29.3</b>
Canada pension plans	Between UP94 C2015 and UP94 C2027	<b>19.0 and 20.0</b>	<b>19.0 and 20.0</b>	<b>21.6 and 22.1</b>	<b>21.6 and 22.1</b>
Canada healthcare plan	UP94 C2025	<b>19.8</b>	<b>19.8</b>	<b>22.0</b>	<b>22.00</b>
Switzerland	BVG 2005 (3% load)	<b>17.9</b>	<b>17.9</b>	<b>21.0</b>	<b>21.0</b>
Germany	Heubeck 2005 G	<b>18.1</b>	<b>20.8</b>	<b>22.2</b>	<b>24.9</b>

1 PA92 with standard improvements to 2005 and medium cohort improvements thereafter.

2 PA92 year of birth with medium cohort improvements.



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The mortality tables and average life expectancy at 65 used at 31 December 2006 were as follows:

	Mortality table	Life expectancy at age 65 for a male member currently:		Life expectancy at age 65 for a female member currently:	
		Aged 65	Aged 45	Aged 65	Aged 45
UK	PA92 <sup>1</sup>	20.3	21.6	23.3	24.6
Hong Kong	n/a	n/a	n/a	n/a	n/a
US	RP 2000 projected to 2005	18.7	18.7	20.9	20.9
Jersey	PA92 <sup>1</sup>	20.3	21.6	23.3	24.6
Mexico	GAM83	16.6	16.6	16.6	16.6
Brazil	RP 2000 imp 2006	18.9	20.5	21.0	21.9
France	TG 05	22.8	25.6	26.3	29.1
Canada pension plans	Between UP94 C2015 and UP94 C2027	19.0 and 20.0	19.0 and 20.0	21.6 and 22.1	21.6 and 22.1
Canada healthcare plan	UP94 C2025	19.8	19.8	22.0	22.0
Switzerland	EVK2000 and BVG2000	17.6 and 17.8	17.6 and 17.8	20.4 and 21.1	20.4 and 21.1
Germany	Heubeck 2005 G	18.1	20.8	22.2	24.9

1 PA92 with standard improvements to 2005 and medium cohort improvements thereafter.

#### Actuarial assumption sensitivities

The discount rate is sensitive to changes in market conditions arising during the reporting period. The mortality rates used are sensitive to experience from the plan member profile. The following table shows the effect of changes in these and the other key assumptions on the principal plan:

	HSBC Bank (UK) Pension Scheme	
	2007 US\$m	2006 US\$m
<b>Discount rate</b>		
Change in pension obligation at year end from a 25bps increase	<b>(989)</b>	(1,086)
Change in pension obligation at year end from a 25bps decrease	<b>1,063</b>	1,147
Change in 2008 pension cost from a 25bps increase	<b>(20)</b>	(20)
Change in 2008 pension cost from a 25bps decrease	<b>20</b>	22
<b>Rate of inflation</b>		
Change in pension obligation at year end from a 25bps increase	<b>1,063</b>	1,147
Change in pension obligation at year end from a 25bps decrease	<b>(989)</b>	(1,086)
Change in 2008 pension cost from a 25bps increase	<b>82</b>	88
Change in 2008 pension cost from a 25bps decrease	<b>(76)</b>	(77)
<b>Rate of increase for pensions in payment and deferred pensions</b>		
Change in pension obligation at year end from a 25bps increase	<b>823</b>	909
Change in pension obligation at year end from a 25bps decrease	<b>(758)</b>	(872)
Change in 2008 pension cost from a 25bps increase	<b>60</b>	57
Change in 2008 pension cost from a 25bps decrease	<b>(56)</b>	(55)

**Rate of pay increase**

Change in pension obligation at year end from a 25bps increase	<b>240</b>	287
Change in pension obligation at year end from a 25bps decrease	<b>(231)</b>	(275)
Change in 2008 pension cost from a 25bps increase	<b>22</b>	31
Change in 2008 pension cost from a 25bps decrease	<b>(20)</b>	(27)

**Mortality**

Change in pension obligation from each additional year of longevity assumed	<b>683</b>	756
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HSBC HOLDINGS PLC

**Notes on the Financial Statements** (continued)**Note 8**

The following table shows the effect of changes in the discount rate and in mortality rates on plans other than the principal plan:

	Other plans	
	2007 US\$m	2006 US\$m
Change in defined benefit obligation at year end from a 25bps increase in discount rate	(312)	(276)
Change in 2008 defined benefit charge from a 25bps increase in discount rate	(8)	(5)
Increase in defined benefit obligation from each additional year of longevity assumed	137	167

## Defined benefit pension plans

The calculation of the net liability under the Group's defined benefit pension plans is set out below together with the expected rates of return and plan assets used to measure the net defined benefit pension costs in each subsequent year.

	HSBC Bank (UK) Pension Scheme			
	2007		2006	
	Expected rates of return %	Value US\$m	Expected rates of return %	Value US\$m
Fair value of plan assets		22,704		20,587
Equities	8.3	4,580	8.0	5,046
Bonds	6.1	15,341	5.3	12,189
Property	7.3	1,878	7.0	2,056
Other	5.1	905	4.3	1,296
Defined benefit obligation		(23,512)		(24,332)
Present value of funded obligations		(23,512)		(24,332)
Present value of unfunded obligations		□		□
Net liability		(808)		(3,745)

  

	Other plans	
	2007	2006
	Expected rates of	Expected rates of

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	return <sub>1</sub> %	Value US\$m	return <sub>1</sub> %	Value US\$m
Fair value of plan assets		<b>7,768</b>		7,116
Equities	<b>8.3</b>	<b>3,439</b>	8.1	3,209
Bonds	<b>5.4</b>	<b>3,452</b>	5.7	3,302
Property	<b>7.3</b>	<b>111</b>	7.0	138
Other	<b>5.7</b>	<b>766</b>	4.6	467
Defined benefit obligation		<b>(8,873)</b>		(7,916)
Present value of funded obligations		<b>(8,453)</b>		(7,534)
Present value of unfunded obligations		<b>(420)</b>		(382)
Effect of limit on plan surpluses		<b>(55)</b>		(9)
Unrecognised past service cost		□		1
Net liability		<b>(1,160)</b>		(808)

1 The expected rates of return are weighted on the basis of the fair value of the plan assets.

Plan assets include US\$86 million (2006: US\$87 million) of equities issued by HSBC and US\$572 million (2006: US\$188 million) of other assets issued by HSBC. The fair value of plan assets includes derivatives entered into with the HSBC Bank (UK) Pension Scheme with a positive fair value of US\$248 million at 31 December 2007 (2006: US\$273 million negative fair value) and US\$63 million positive fair value (2006: US\$14 million positive fair value) in respect of The HSBC International Staff Retirements Benefit Scheme. Further details of these swap arrangements are included in Note 44.

[Back to Contents](#)**Changes in the present value of defined benefit obligations**

	HSBC Bank (UK) Pension Scheme		Other plans	
	2007 US\$m	2006 US\$m	2007 US\$m	2006 US\$m
At 1 January	24,332	20,587	7,916	7,102
Current service cost	454	456	347	304
Interest cost	1,247	1,055	398	366
Contributions by employees	□	□	37	28
Actuarial (gains)/losses	(2,395)	30	475	211
Benefits paid	(632)	(696)	(529)	(386)
Past service cost □ vested immediately	□	□	6	9
Acquisitions	□	□	□	10
Reduction in liabilities resulting from curtailments	□	□	(63)	(5)
Liabilities extinguished on settlements	□	□	(16)	(21)
Exchange differences	506	2,900	302	298
At 31 December	23,512	24,332	8,873	7,916

**Changes in the fair value of plan assets**

	HSBC Bank (UK) Pension Scheme		Other plans	
	2007 US\$m	2006 US\$m	2007 US\$m	2006 US\$m
At 1 January	20,587	17,396	7,116	6,356
Expected return on plan assets	1,211	1,169	486	421
Contributions by HSBC	1,058	240	211	193
□ normal	471	240	199	160
□ special	587	□	12	33
Contributions by employees	□	□	37	28
Experience gains	29	□	157	203
Benefits paid	(632)	(696)	(467)	(343)
Assets distributed on curtailments	□	□	□	(4)
Assets distributed on settlements	□	□	(17)	(14)
Exchange differences	451	2,478	245	276
At 31 December	22,704	20,587	7,768	7,116

The actual return on plan assets for the year ended 31 December 2007 was US\$1,883 million (2006: US\$1,793 million). HSBC expects to make US\$671 million of contributions to defined benefit pension plans

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during 2008. Benefits expected to be paid from the plans to retirees over each of the next five years, and in aggregate for the five years thereafter, are:

	2008 US\$m	2009 US\$m	2010 US\$m	2011 US\$m	2012 US\$m	2013-2017 US\$m
HSBC Bank (UK) Pension Scheme	712	726	770	801	853	5,419
Other significant plans	446	448	467	504	548	3,084

**Total expense recognised in the income statement in**  
**Employee compensation and benefits**

	HSBC Bank (UK) Pension Scheme			Other plans		
	2007 US\$m	2006 US\$m	2005 US\$m	2007 US\$m	2006 US\$m	2005 US\$m
Current service cost	454	456	383	347	304	283
Interest cost	1,247	1,055	981	398	366	333
Expected return on plan assets	(1,211)	(1,169)	(954)	(486)	(421)	(401)
Past service cost	□	□	□	7	11	(3)
(Gains)/losses on curtailments	□	□	□	(63)	□	(4)
(Gains)/losses on settlements	□	□	□	1	□	□
<b>Total expense</b>	<b>490</b>	<b>342</b>	<b>410</b>	<b>204</b>	<b>260</b>	<b>208</b>

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HSBC HOLDINGS PLC

**Notes on the Financial Statements** (continued)**Note 8****Summary**

## HSBC Bank (UK) Pension Scheme

	<b>2007</b>	2006	2005	2004
	<b>US\$m</b>	US\$m	US\$m	US\$m
Defined benefit obligation	<b>(23,512)</b>	(24,332)	(20,587)	(19,988)
Fair value of plan assets	<b>22,704</b>	20,587	17,396	15,105
<b>Net deficit</b>	<b>(808)</b>	(3,745)	(3,191)	(4,883)
Experience gains/(losses) on plan liabilities	<b>(64)</b>	540	70	401
Experience gains on plan assets	<b>29</b>	□	1,623	506
Gains/(losses) from changes in actuarial assumptions	<b>2,459</b>	(570)	(2,038)	(1,357)
<b>Total net actuarial gains/(losses)</b>	<b>2,424</b>	(30)	(345)	(450)

## Other plans

	<b>2007</b>	2006	2005	2004
	<b>US\$m</b>	US\$m	US\$m	US\$m
Defined benefit obligation	<b>(8,873)</b>	(7,916)	(7,102)	(6,501)
Fair value of plan assets	<b>7,768</b>	7,116	6,356	5,823
<b>Net deficit</b>	<b>(1,105)</b>	(800)	(746)	(678)
Experience losses on plan liabilities	<b>(354)</b>	(167)	(113)	(42)
Experience gains on plan assets	<b>157</b>	203	78	3
Losses from changes in actuarial assumptions	<b>(121)</b>	(44)	(393)	(243)
<b>Total net actuarial gains/(losses)</b>	<b>(318)</b>	(8)	(428)	(282)

Actuarial gains and losses represent experience adjustments on plan assets and liabilities as well as adjustments arising from changes in actuarial assumptions. Total cumulative actuarial gains recognised in equity at 31 December 2007 were US\$563 million (2006: US\$1,543 million cumulative losses).

The total effect of the limit on plan surpluses recognised within actuarial losses in equity during 2007 was a US\$42 million loss excluding exchange differences of US\$4 million (2006: US\$2 million loss and exchange difference of nil).

## Defined benefit healthcare plans

	<b>2007</b>	2006
	<b>Expected</b>	Expected

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	rates of return <sup>1</sup> %	Value US\$m	rates of return <sup>1</sup> %	Value US\$m
Fair value of plan assets		<b>146</b>		133
Equities	<b>13.0</b>	<b>44</b>	14.5	40
Bonds	<b>7.9</b>	<b>102</b>	8.5	93
Defined benefit obligation		<b>(1,038)</b>		(1,106)
Present value of funded obligations		<b>(191)</b>		(219)
Present value of unfunded obligations		<b>(847)</b>		(887)
Unrecognised past service cost		<b>(33)</b>		(29)
Net liability		<b>(925)</b>		(1,002)

<sup>1</sup> *The expected rates of return are weighted on the basis of the fair value of the plan assets.*  
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[Back to Contents](#)**Changes in the present value of defined benefit obligations**

	2007 US\$m	2006 US\$m
At 1 January	1,106	1,004
Current service cost	25	19
Interest cost	67	64
Contributions by employees	2	2
Actuarial (gains)/losses	(109)	37
Benefits paid	(54)	(52)
Past service cost:		
□ vested immediately	(2)	1
□ unvested benefits	(2)	□
Reduction in liabilities resulting from curtailments	(42)	(9)
Liabilities extinguished on settlements	(2)	(1)
Exchange differences	49	41
	<hr/>	<hr/>
At 31 December	1,038	1,106

**Changes in the fair value of plan assets**

	2007 US\$m	2006 US\$m
At 1 January	133	107
Expected return on plan assets	13	11
Contributions by HSBC	19	39
Experience gains/(losses)	(6)	(1)
Benefits paid	(11)	(20)
Assets distributed on curtailments	□	(1)
Assets distributed on settlements	(2)	□
Exchange differences	□	(2)
	<hr/>	<hr/>
At 31 December	146	133

The actual return on plan assets for the year ended 31 December 2007 was US\$7 million (2006: US\$10 million).

HSBC expects to make US\$18 million (2006: US\$19 million) of contributions to post-employment healthcare benefit plans during 2008. Benefits expected to be paid from the plans to retirees over each of the next five years, and in aggregate for the five years thereafter, are:

	2008 US\$m	2009 US\$m	2010 US\$m	2011 US\$m	2012 US\$m	2013-2017 US\$m
Significant plans	50	52	54	56	58	309

**Total expense recognised in the income statement in □Employee compensation and benefits□**

	2007 US\$m	2006 US\$m	2005 US\$m
Current service cost	25	19	18
Interest cost	67	64	63
Expected return on plan assets	(13)	(11)	(10)
Past service cost	(4)	(1)	(13)
Losses on curtailments	(42)	(8)	□

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Losses on settlements	<u>□</u>	<u>(1)</u>	<u>□</u>
Total expense	<u>33</u>	<u>62</u>	<u>58</u>

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HSBC HOLDINGS PLC

**Notes on the Financial Statements** (continued)

Notes 8 and 9

**Summary**

	<b>2007</b>	2006	2005	2004
	<b>US\$m</b>	US\$m	US\$m	US\$m
Defined benefit obligation	<b>(1,038)</b>	(1,106)	(1,004)	(982)
Fair value of plan assets	<b>146</b>	133	107	79
Net deficit	<b>(892)</b>	(973)	(897)	(903)
Experience gains/(losses) on plan liabilities	<b>15</b>	(12)	19	(15)
Experience gains/(losses) on plan assets	<b>(6)</b>	(1)	1	□
Gains/(losses) from changes in actuarial assumptions	<b>94</b>	(25)	(63)	20
Total net actuarial gains/(losses)	<b>103</b>	(38)	(43)	5

Actuarial gains and losses represent experience adjustments on plan assets and liabilities as well as adjustments arising from changes in actuarial assumptions. Total cumulative net actuarial gains recognised in equity at 31 December 2007 were US\$27 million (2006: US\$76 million cumulative losses).

The actuarial assumptions of the healthcare cost trend rates have a significant effect on the amounts recognised. A one percentage point change in assumed healthcare cost trend rates would have the following effects on amounts recognised in 2007:

	<b>2007</b>		2006	
	<b>1% increase US\$m</b>	<b>1% decrease US\$m</b>	1% increase US\$m	1% decrease US\$m
Increase/(decrease) of the aggregate of the current service cost and interest cost	<b>14</b>	<b>(10)</b>	8	(6)
Increase/(decrease) of defined benefit obligation	<b>110</b>	<b>(100)</b>	103	(111)

**HSBC Holdings**

Employee compensation and benefit expense in respect of HSBC Holdings' employees in 2007 amounted to US\$257 million (2006: US\$193 million). The average number of persons employed by HSBC Holdings during 2007 was 595 (2006: 505).

Employees of HSBC Holdings who are members of defined benefit pension plans are principally members of either the HSBC Bank (UK) Pension Scheme or the HSBC International Staff Retirement Benefit Scheme. HSBC Holdings pays contributions to plans in accordance with schedules determined by the Trustees following consultation with qualified actuaries.

**Directors' emoluments**

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The aggregate emoluments of the Directors of HSBC Holdings, computed in accordance with Part I of Schedule 6 of the Companies Act, were:

	<b>2007</b>	2006	2005
	<b>US\$000</b>	US\$000	US\$000
Fees	<b>2,626</b>	2,660	2,100
Salaries and other emoluments	<b>7,929</b>	7,774	12,869
Bonuses	<b>8,938</b>	10,705	13,264
	<b>19,493</b>	21,139	28,233
Gains on the exercise of share options	<b>13</b>	3	17
Vesting of Long-Term Incentive awards	<b>4,563</b>	18,975	24,221

In addition, there were payments under retirement benefit agreements with former Directors of US\$1,183,960 (2006: US\$996,098). The provision at 31 December 2007 in respect of unfunded pension obligations to former Directors amounted to US\$18,491,117 (2006: US\$17,759,454).

During the year, aggregate contributions to pension schemes in respect of Directors were US\$545,854 (2006: US\$889,241), including US\$460,564 (2006: US\$395,740) arising from a Director's waiver of bonus.

Discretionary bonuses for Directors are based on a combination of individual and corporate performance and are determined by the Remuneration Committee. Details of Directors' remuneration, share options and conditional

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awards under the Restricted Share Plan 2000 and The HSBC Share Plan are included in the [Directors' Remuneration Report](#) on pages 322 to 332.

## 9 Auditors' remuneration

Auditors' remuneration in relation to the statutory audit amounted to US\$52.3 million (2006: US\$44.7 million; 2005: US\$47.0 million). The following fees were payable by HSBC to the Group's principal auditor, KPMG Audit Plc and its associates (together [KPMG](#)):

	2007 US\$m	2006 US\$m	2005 US\$m
Audit fees for HSBC Holdings' statutory audit	3.0	2.7	3.0
fees relating to current year	3.0	2.7	2.8
fees relating to prior year	-	-	0.2
Fees payable to KPMG for other services provided to HSBC	79.1	64.1	79.6
Audit-related services:			
audit of HSBC's subsidiaries, pursuant to legislation	45.2	40.4	42.5
other services pursuant to legislation <sup>3</sup>	19.4	15.4	29.2
Tax services <sup>4</sup>	2.9	2.0	2.6
Other services:			
services relating to information technology <sup>5</sup>	0.4	0.6	-
services related to corporate finance transactions <sup>6</sup>	1.8	1.6	0.3
all other services <sup>7</sup>	9.4	4.1	5.0
<b>Total fees payable</b>	<b>82.1</b>	<b>66.8</b>	<b>82.6</b>

- Fees payable to KPMG Audit Plc for the statutory audit of the consolidated financial statements of HSBC and the separate financial statements of HSBC Holdings. They exclude amounts payable for the statutory audit of HSBC Holdings' subsidiaries which have been included in Fees payable to KPMG for other services provided to HSBC.*
- Including fees payable to KPMG for the statutory audit of HSBC's subsidiaries.*
- Including services for assurance and other services that relate to statutory and regulatory filings, including comfort letters and interim reviews. Other services pursuant to legislation included fees paid to KPMG in respect of work relating to preparation for reporting under section 404 of the Sarbanes-Oxley Act of US\$1.6 million (2006: US\$2.2 million; 2005: US\$11.7 million). Other accounting firms were paid a total of US\$2.5 million (2006: US\$8.3 million; 2005: US\$16.7 million) for work on this project.*
- Including tax compliance services and tax advisory services.*
- Including advice on IT security and business continuity and performing agreed-upon IT testing procedures.*
- Including fees payable to KPMG for transaction-related work, including US debt issuances.*
- Including other assurance and advisory services such as translation services, ad-hoc accounting advice and review of financial models.*

No fees were payable by HSBC to KPMG for the following types of services: internal audit services, valuation and actuarial services, services related to litigation, and services related to recruitment and remuneration. The following fees were payable by HSBC's associated pension schemes to KPMG:

	2007 US\$000	2006 US\$000	2005 US\$000
Audit fees	612	581	550
Tax services	14	23	17
All other services	36	23	5
<b>Total fees payable</b>	<b>662</b>	<b>627</b>	<b>572</b>

No fees were payable by HSBC's associated pension schemes to KPMG for the following types of services: other services pursuant to legislation, services relating to information technology, internal audit services, valuation and actuarial services, services related to litigation, services related to recruitment and remuneration, and services related to corporate finance transactions.

In addition to the above, KPMG estimate they have been paid fees of US\$3.4 million (2006: US\$2.1 million; 2005: US\$4.5 million) by parties other than HSBC but where HSBC is connected with the contracting party and therefore may be involved in appointing KPMG. These fees arise from services such as auditing mutual funds managed by HSBC and reviewing the financial position of corporate concerns which borrow from HSBC.

Fees payable to KPMG for non-audit services for HSBC Holdings are not disclosed separately because such fees are disclosed on a consolidated basis for HSBC Group.

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**Notes on the Financial Statements** (continued)**Note 10****10 Share-based payments**

During 2007, US\$870 million was charged to the income statement in respect of share-based payment transactions settled in equity (2006: US\$854 million; 2005: US\$540 million). This expense, which was computed from the fair values of the share-based payment transactions when contracted, arose under employee share awards made in accordance with HSBC's reward structures.

## Calculation of fair values

Fair values of share options/awards, measured at the date of grant of the option/award, are calculated using a binomial lattice model methodology that is based on the underlying assumptions of the Black-Scholes model. When modelling options/awards with vesting dependent on HSBC's Total Shareholder Return (TSR) over a period, the TSR performance targets are incorporated into the model using Monte Carlo simulation. The expected life of options depends on the behaviour of option holders, which is incorporated into the option model on the basis of historic observable data. The fair values calculated are inherently subjective and uncertain due to the assumptions made and the limitations of the model used.

The significant weighted average assumptions used to estimate the fair value of the options granted were as follows:

	<b>HSBC Holdings Group Share Option  Plan</b>	<b>1-year Savings- Related Share Option  Plan</b>	<b>3-year Savings- Related Share Option  Plans</b>	<b>5-year Savings- Related Share Option  Plans</b>	<b>The HSBC Share Plan</b>
<b>2007</b>					
Risk-free interest rate <sup>1</sup> (%)	□	5.6	5.5	5.4	□
Expected life <sup>2</sup> (years)	□	1	3	5	□
Expected volatility <sup>3</sup> (%)	□	17	17	17	□
Share price at grant date (£)	□	9.24	9.24	9.24	□
<b>2006</b>					
Risk-free interest rate <sup>1</sup> (%)	□	4.7	4.8	4.7	□
Expected life <sup>2</sup> (years)	□	1	3	5	□
Expected volatility <sup>3</sup> (%)	□	17	17	17	□
Share price at grant date (£)	□	9.54	9.54	9.54	□
<b>2005</b>					
Risk-free interest rate <sup>1</sup> (%)	4.6	□	4.3	4.3	4.3
Expected life <sup>2</sup> (years)	7.8	□	3	5	5
Expected volatility <sup>3</sup> (%)	20	□	20	20	20
Share price at grant date (£)	8.30	□	8.68	8.68	8.37

1 The risk-free rate was determined from the UK gilts yield curve for the HSBC Holdings Group Share Option Plan awards and UK Savings-Related Share Option Plans. A similar yield curve was used for the International Savings-Related Share Option Plans.

2 Expected life is not a single input parameter but a function of various behavioural assumptions.

3 Expected volatility is estimated by considering both historic average share price volatility and implied volatility derived from traded options over HSBC shares of similar maturity to those of the employee

*options.*

Expected dividends are incorporated into the valuation model for options and shares, where applicable. The expected US dollar denominated dividend growth was determined to be 10 per cent for the first 3 years (2006: 9 per cent for first year) and 8 per cent thereafter (2006: 8 per cent), in line with consensus analyst forecasts.

#### The HSBC Share Plan

The HSBC Share Plan was adopted by HSBC Holdings in 2005. Under this plan, performance share awards, restricted share awards and share option awards may be made. The aim of the HSBC Share Plan is to align the interests of executives with the creation of shareholder value and recognise individual performance and potential. Awards are also made under this plan for recruitment and retention purposes.

#### **Performance share awards**

Performance shares are awarded to executive Directors and other senior executives after taking into account individual performance in the previous year. Each award is divided into two equal parts for testing attainment against pre-determined benchmarks. One half of the award is subject to a TSR measure, based on HSBC's ranking against a comparator group of 28 major banks; the other half is subject to an earnings per share target. For each element of the



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award, shares are released to the employee on a sliding scale from 30 to 100 per cent of the award, depending on the scale of achievement against the benchmarks, providing that the minimum criteria for each performance measure has been met and subject to the Remuneration Committee being satisfied that HSBC's financial performance has shown a sustained improvement in the period since the award date. The shares vest after three years to the extent that the vesting conditions are satisfied.

	<b>2007</b>	2006
	<b>Number</b>	Number
	<b>(000's)</b>	(000's)
Outstanding at 1 January	<b>10,367</b>	5,077
Additions during the year	<b>3,263</b>	5,312
Forfeited in the year	<b>(1,312)</b>	(22)
	<hr/>	<hr/>
Outstanding at 31 December	<b>12,318</b>	10,367
	<hr/>	<hr/>

The weighted average fair value of shares awarded by HSBC for performance share awards in 2007 was US\$13.24 (2006: US\$13.31) .

### Restricted share awards

Restricted shares are awarded to other employees on the basis of their performance, potential and retention requirements, to aid recruitment or as a part-deferral of annual bonuses. Shares are awarded without corporate performance conditions and generally vest between one and three years from the date of award, providing the employees have remained continually employed by HSBC for this period.

	<b>2007</b>	2006
	<b>Number</b>	Number
	<b>(000's)</b>	(000's)
Outstanding at 1 January	<b>43,420</b>	5,106
Additions during the year	<b>52,790</b>	41,440
Released in the year	<b>(8,781)</b>	(1,685)
Forfeited in the year	<b>(8,173)</b>	(1,441)
	<hr/>	<hr/>
Outstanding at 31 December	<b>79,256</b>	43,420
	<hr/>	<hr/>

The weighted average fair value of shares awarded by HSBC for restricted share awards in 2007 was US\$17.92 (2006: US\$17.65) .

### Share options

Share options were granted in 2005 under The HSBC Share Plan to employees in France on the basis of their performance in the previous year. The share options are subject to the corporate performance conditions, which consist of an absolute earnings per share measure and a TSR measure based on HSBC Holdings' ranking against a comparator group of 28 major banks. The options may vest after three years and are exercisable up to the tenth anniversary of the date of grant, after which they will lapse.

<b>2007</b>		2006	
<b>Number</b>	<b>Weighted average exercise price</b>	Number	Weighted average exercise price
<b>(000's)</b>	<b>£</b>	(000's)	£

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Outstanding at 1 January	<b>628</b>	<b>8.84</b>	628	8.84
Forfeited in the year	<b>(104)</b>	<b>8.79</b>	□	□
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Outstanding at 31 December	<b>524</b>	<b>8.85</b>	628	8.84
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>

No options were granted in 2007 (2006: nil). The weighted average remaining contractual life of options outstanding at the balance sheet date was 2.4 years (2006: 3.3 years). The exercise price range of options outstanding at the balance sheet date was £8.79 - £9.17. None of these options were exercisable at the balance sheet date.

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**Notes on the Financial Statements** (continued)**Note 10**

## Savings-related share option plans

Savings-related share option plans invite eligible employees to enter into savings contracts to save up to £250 per month (or its equivalent in US dollars, Hong Kong dollars or euros), with the option to use the savings to acquire shares. The aim of the plans is to align the interests of all employees with the creation of shareholder value. The options are exercisable within three months following the first anniversary of the commencement of a one-year savings contract or within six months following either the third or the fifth anniversaries of the commencement of three-year or five-year savings contracts, respectively. The exercise price is set at a 20 per cent (2006: 20 per cent) discount to the market value immediately preceding the date of invitation (except for the one-year options granted under the US sub-plan where a 15 per cent discount is applied).

		2007		2006			
		Number (000's)	Weighted average exercise price	Number	Weighted average exercise price		
£ (000's)	£	Outstanding at 1 January	<b>87,837</b>	6.07	Granted in the year	<b>30,105</b>	<b>7.43</b>
22,627	7.63	Exercised in the year	<b>(17,951)</b>	6.58	(25,336)	5.61	Forfeited in the year
					<b>(10,252)</b>	<b>6.58</b>	(7,870)
							6.26
Outstanding at 31 December		<b>89,739</b>	<b>6.83</b>	87,837	6.58		

The weighted average fair value of options granted during the year was US\$4.24 (2006: US\$3.45). The exercise price range and weighted average remaining contractual life for options outstanding at the balance sheet date were as follows:

	2007	2006
Exercise price range (£)	<b>5.35 - 7.93</b>	5.35 - 7.93
Weighted average remaining contractual life (years)	<b>1.67</b>	1.76
Of which exercisable:		
Number (000's)	<b>541</b>	671
Weighted average exercise price (£)	<b>6.44</b>	5.35

The weighted average share price at the date the share options were exercised was US\$17.93 (2006: US\$17.55).

## HSBC Holdings Restricted Share Plan 2000

**Performance share awards made under the HSBC Holdings Restricted Share Plan 2000 (the Restricted Share Plan)**

Performance share awards under the Restricted Share Plan were granted to senior executives from 2000 to 2004. The aim of the plan was to align the interests of

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executives with the creation of shareholder value. This was achieved by setting certain TSR targets against a peer group of major banks which would normally have to be attained in order for the awards to vest. In addition to these performance conditions, none of the outstanding awards will vest unless the Remuneration Committee is satisfied that, during the performance period, HSBC has achieved sustained growth. Following adoption of The HSBC Share Plan in 2005, no further awards will be made under this Plan other than from reinvested scrip dividends.

	<b>2007</b>	2006
	<b>Number</b>	Number
	<b>(000)s</b>	(000)s
Outstanding at 1 January	<b>12,328</b>	14,970
Additions during the year <sup>1</sup>	<b>301</b>	520
Released in the year	<b>(2,332)</b>	(3,050)
Forfeited in the year	<b>(5,486)</b>	(112)
	<hr/>	<hr/>
Outstanding at 31 December	<b>4,811</b>	12,328
	<hr/>	<hr/>

1 Additions during the year comprised reinvested scrip dividends.

The weighted average remaining vesting period as at 31 December 2007 was 0.2 years (2006: 1.5 years).

[Back to Contents](#)**Restricted share awards made under the Restricted Share Plan**

Restricted share awards under the Restricted Share plan were granted to eligible employees from 2000 to 2005, after taking into account the employees' performance in the previous year, their potential and retention requirements. Restricted shares were also awarded as part-deferral of annual bonuses or for recruitment purposes. Shares were awarded without corporate performance conditions and generally vest between one and three years from the date of award, providing the employees have remained continuously employed by HSBC for the period.

	<b>2007</b> <b>Number</b> <b>(000's)</b>	2006 Number (000's)
Outstanding at 1 January	<b>38,670</b>	58,427
Additions during the year <sup>1</sup>	<b>199</b>	1,499
Released in the year	<b>(17,156)</b>	(19,224)
Forfeited in the year	<b>(2,414)</b>	(2,032)
Outstanding at 31 December	<b>19,299</b>	38,670

1 Additions during the year comprised reinvested scrip dividends.

The weighted average remaining vesting period as at 31 December 2007 was 0.3 years (2006: 0.8 years).

**HSBC Holdings Group Share Option Plan**

The HSBC Holdings Group Share Option Plan was a long-term incentive plan under which certain HSBC employees between 2000 and 2005 were awarded share options. The aim of the plan was to align the interests of those higher performing employees with the creation of shareholder value. This was achieved by setting certain TSR targets which would normally have to be attained in order for the awards to vest. Options were granted at market value and are normally exercisable between the third and tenth anniversaries of the date of grant, subject to vesting conditions. Options granted after May 2005 are made under The HSBC Share Plan.

	<b>2007</b>		2006	
	<b>Number</b> <b>(000's)</b>	<b>Weighted</b> <b>average</b> <b>exercise</b> <b>price</b> <b>£</b>	Number (000's)	Weighted average exercise price £
Outstanding at 1 January	<b>168,786</b>	<b>8.09</b>	209,982	8.06
Exercised in the year	<b>(8,351)</b>	<b>7.64</b>	(37,817)	7.80
Forfeited in the year	<b>(8,222)</b>	<b>8.02</b>	(3,379)	8.29
Outstanding at 31 December	<b>152,213</b>	<b>8.15</b>	168,786	8.09

The number of options, weighted average exercise price, and weighted average remaining contractual life of options outstanding at the balance sheet date, analysed by exercise price range, were as follows:

	<b>2007</b>	2006
Exercise price range (£)	<b>6.00 – 8.00</b>	6.00 – 8.00 8.01 – 10.00

		<b>8.01</b>		
		<b>10.00</b>		
Number (000's)	<b>29,312</b>	<b>122,901</b>	34,903	131,725
Weighted average exercise price (£)	<b>6.92</b>	<b>8.44</b>	6.92	8.40
Weighted average remaining contractual life (years)	<b>5.33</b>	<b>5.34</b>	4.74	7.17
Of which exercisable:				
Number (000's)	<b>29,312</b>	<b>61,650</b>	34,903	66,104
Weighted average exercise price (£)	<b>6.92</b>	<b>8.59</b>	6.92	8.58

The weighted average share price at the date the share options were exercised was US\$18.08 (2006: US\$17.65) .

In 2006, after consideration of the performance and shareholder returns over the period between 2003 and 2005, the Remuneration Committee exercised its discretion to waive the TSR performance condition in respect of the awards made under this plan in 2003. As a result, a charge of US\$135 million was recognised in 2006, reflecting the incremental fair value granted measured at the date the performance condition was waived. This was measured using a binomial lattice model methodology that is based on the underlying assumptions of the Black-Scholes model, as

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HSBC HOLDINGS PLC

**Notes on the Financial Statements** (continued)*Notes 10 and 11*

described above in [Calculation of fair values]. A risk-free interest rate of 4.3 per cent was used, with all other inputs to the model consistent with those used to value the other share options and awards made during 2006.

**HSBC Holdings Executive Share Option Scheme**

The HSBC Holdings Executive Share Option Scheme was a long-term incentive plan under which certain senior HSBC employees were awarded share options before the adoption of the HSBC Holdings Group Share Option Plan in 2000. The aim of the plan was to align the interests of those higher performing senior employees with the creation of shareholder value. This was achieved by setting certain TSR targets to be attained in order for the awards to vest. Options were granted at market value and were exercisable between the third and tenth anniversaries of the date of grant, subject to vesting conditions. No awards have been made under this plan since 2000 and the remaining unexercised options are summarised below:

	2007		2006	
	Number (000's)	Weighted average exercise price £	Number (000's)	Weighted average exercise price £
Outstanding at 1 January	22,037	6.82	32,255	6.78
Exercised in the year	(3,377)	6.65	(9,767)	6.69
Forfeited in the year	(421)	6.84	(451)	5.94
Outstanding at 31 December	18,239	6.85	22,037	6.82

The weighted average share price at the date the share options were exercised was US\$18.08 (2006: US\$17.65).

The number of options, weighted average exercise price and weighted average remaining contractual life of options outstanding at the balance sheet date, analysed by exercise price range, were as follows:

	2007		2006	
	6.01 - 7.87	2.17 - 6.00	6.01 - 7.87	
Exercise price range (£)	6.01 - 7.87	2.17 - 6.00	6.01 - 7.87	
Number (000's)	18,239	188	21,849	
Weighted average exercise price (£)	6.85	5.02	6.84	
Weighted average remaining contractual life (years)	1.66		2.64	
Of which exercisable:				
Number (000's)	18,239	188	21,849	
Weighted average exercise price (£)	6.85	5.02	6.84	

**HSBC France and subsidiary company plans**

Before its acquisition by HSBC in 2000, HSBC France and certain of its subsidiaries operated employee share plans under which share options were granted over their respective shares.

Options over HSBC France shares granted between 1994 and 1999 vested upon announcement of HSBC's agreement to acquire HSBC France and were therefore included in the valuation of HSBC France.

HSBC France granted 909,000 options in 2000 after the public announcement of the acquisition and these options did not vest as a result of the change in control. The options were subject to continued employment and vested on 1 January 2002. The HSBC France shares obtained on exercise of the options are exchangeable for HSBC's ordinary shares of US\$0.50 each in the same ratio as the Exchange Offer for HSBC France shares (13 ordinary shares of US\$0.50 for each HSBC France share). Options were granted at market value and are exercisable within 10 years of the date of grant.

	2007		2006	
	Number (000's)	Exercise price □	Number (000's)	Exercise price □
Outstanding at 1 January	646	142.5	766	142.5
Exercised in the year	(44)	142.5	(120)	142.5
Outstanding and exercisable at 31 December	602	142.5	646	142.5

The remaining contractual life for options outstanding at the balance sheet date was 2.3 years (2006: 3.3 years)



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The weighted average share price at the date the share options were exercised was US\$18.08 (2006: US\$17.64) .

At the date of its acquisition in 2000, certain of HSBC France's subsidiary companies also operated employee share option plans under which options could be granted over their respective shares. On exercise of certain of these options, the subsidiary shares are exchanged for HSBC ordinary shares. The total number of HSBC ordinary shares exchanged under such arrangements in 2007 was 113,240 (2006: 356,491).

#### HSBC Finance Corporation

Upon acquisition, HSBC Finance share options previously granted were converted to share options over HSBC ordinary shares of US\$0.50 each at a rate of 2.675 HSBC share options (the same ratio as the Exchange Offer for HSBC Finance) for each HSBC Finance share option. Options granted under HSBC Finance's own share option schemes prior to the announcement of the acquisition by HSBC in November 2002 vested as options over HSBC shares upon acquisition by HSBC. Options granted after the announcement of the acquisition in November 2002 but prior to its completion on 28 March 2003 generally vest equally over four years and expire ten years from the date of grant.

Information with respect to share options granted under HSBC Finance's pre-acquisition scheme is as follows:

	2007		2006	
	Number (000's)	Exercise price US\$	Number (000's)	Exercise price US\$
HSBC Finance share options outstanding at 1 January	3,126	10.66	6,358	10.66
Exercised in the year	(671)	10.66	(3,219)	10.66
Forfeited in the year	□	10.66	(13)	10.66
Outstanding and exercisable at 31 December	2,455	10.66	3,126	10.66

The remaining contractual life for options outstanding at the balance sheet date was 4.9 years (2006: 5.9 years). The weighted average share price at the date the share options were exercised was US\$18.08 (2006: US\$17.65) .

## 11 Tax expense

	2007 US\$m	2006 US\$m	2005 US\$m
<b>Current tax</b>			
UK corporation tax charge □ on current year profit	1,372	772	663
UK corporation tax charge □ adjustments in respect of prior years	(46)	(122)	29
Overseas tax □ on current year profit	3,976	4,600	4,103
Overseas tax □ adjustments in respect of prior years	(97)	(48)	(110)
	5,205	5,202	4,685
<b>Deferred tax</b>			
Origination and reversal of temporary differences	(1,247)	(51)	506
Effect of changes in tax rates	(35)	□	8
Adjustments in respect of prior years	(166)	64	(106)
	(1,448)	13	408
Tax expense	3,757	5,215	5,093

The UK corporation tax rate applying to HSBC Holdings and its subsidiaries was 30 per cent (2006: 30 per cent; 2005: 30 per cent). Overseas tax included Hong Kong profits tax of US\$1,137 million (2006: US\$751 million; 2005: US\$639 million). Subsidiaries in Hong Kong provided for Hong Kong profits tax at the rate of 17.5 per cent (2006: 17.5 per cent; 2005: 17.5 per cent) on the profits for the year assessable in Hong Kong. Other overseas subsidiaries and overseas branches provided for taxation at the appropriate rates in the countries in which they operate.

The following table reconciles the tax expense which would apply if all profits had been taxed at the UK corporation tax rate:

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**Notes on the Financial Statements** (continued)**Note 11**

	2007		2006		2005	
	US\$m	%	US\$m	%	US\$m	%
<b>Analysis of tax expense</b>						
Taxation at UK corporation tax rate of 30% (2006 and 2005: 30% )	<b>7,264</b>	<b>30.0</b>	6,626	30.0	6,290	30.0
Effect of taxing overseas profits in principal locations at different rates	<b>(1,460)</b>	<b>(6.0)</b>	(568)	(2.6)	(342)	(1.6)
Tax-free gains	<b>(296)</b>	<b>(1.2)</b>	(199)	(0.9)	(220)	(1.0)
Adjustments in respect of prior period liabilities	<b>(309)</b>	<b>(1.3)</b>	(106)	(0.5)	(187)	(0.9)
Low income housing tax credits <sup>1</sup>	<b>(107)</b>	<b>(0.4)</b>	(108)	(0.5)	(110)	(0.5)
Effect of profit in associates and joint ventures	<b>(450)</b>	<b>(1.9)</b>	(253)	(1.1)	(193)	(0.9)
Effect of previously unrecognised temporary differences <sup>2</sup>	<b>(485)</b>	<b>(2.0)</b>	(122)	(0.6)	(147)	(0.8)
Release of deferred tax consequent on restructuring of Group interests	<b>(359)</b>	<b>(1.5)</b>	□	□	□	□
Impact of gains arising from dilution of interests in associates <sup>3</sup>	<b>(253)</b>	<b>(1.0)</b>	□	□	□	□
Other items	<b>212</b>	<b>0.8</b>	(55)	(0.2)	2	□
<b>Overall tax expense</b>	<b>3,757</b>	<b>15.5</b>	5,215	23.6	5,093	24.3

- Low income housing tax credits arise in the US and are designed to encourage the provision of rental housing for low income households.*
- The effect of previously unrecognised temporary differences principally relates to the recognition of capital losses.*
- The gains arising from the dilution of HSBC's interests in associates are not subject to tax and, as such, there is a reconciling item which reduces the effective tax rate (see note 21).*

In addition to the amount charged to the income statement, the aggregate amount of current and deferred tax, relating to items that are taken directly to total equity, was a US\$226 million reduction in total equity (2006: US\$44 million reduction in total equity; 2005: US\$437 million increase in total equity).

The 2007 Finance Act reduction in the UK corporation tax rate from 30 per cent to 28 per cent, enacted in 2007 but commencing in 2008, resulted in a one off re-measurement of deferred tax assets and liabilities. It gave rise to a credit to the Group's tax charge of US\$28 million.

## Deferred taxation

**HSBC**

	2007 US\$m	2006 US\$m
At 1 January	<b>2,145</b>	2,135
Income statement credit/(charge)	<b>1,448</b>	(13)
Equity:		
□ available-for-sale investments	<b>(8)</b>	(2)
□ cash flow hedges	<b>470</b>	321
□ share-based payments	<b>(65)</b>	(42)

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□ actuarial gains and losses	<b>(642)</b>	(324)
Foreign exchange and other adjustments	<b>77</b>	70
	<hr/>	<hr/>
At 31 December	<b>3,425</b>	2,145
	<hr/>	<hr/>
Asset	<b>5,284</b>	3,241
Liability	<b>(1,859)</b>	(1,096)
	<hr/>	<hr/>
	<b>3,425</b>	2,145
	<hr/>	<hr/>

The amount of deferred taxation accounted for in the Group balance sheet, before netting off balances within countries, comprised the following deferred tax liabilities and assets:

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	<b>2007</b>	2006
	<b>US\$m</b>	US\$m
<b>Deferred tax assets</b>		
Retirement benefits	<b>822</b>	1,599
Loan impairment allowances	<b>4,484</b>	2,775
Unused tax losses	<b>272</b>	180
Accelerated capital allowances	<b>97</b>	91
Available-for-sale investments	<b>77</b>	□
Cash flow hedges	<b>570</b>	139
Share-based payments	<b>326</b>	194
Other short term timing differences	<b>900</b>	462
Other timing differences	□	80
	<b>7,548</b>	5,520
<b>Deferred tax liabilities</b>		
Assets leased to customers	<b>1,285</b>	1,676
Revaluation of property	<b>507</b>	469
Accelerated capital allowances	<b>206</b>	171
Other short-term timing differences	<b>202</b>	□
Provision for tax on profit remitted from overseas	<b>102</b>	112
Available-for-sale investments	<b>198</b>	384
Cash flow hedges	<b>96</b>	34
Other timing differences	<b>1,527</b>	529
	<b>4,123</b>	3,375
Net deferred tax asset/(liability)	<b>3,425</b>	2,145

After netting off balances within countries, the balances as disclosed in the accounts are as follows:

	<b>2007</b>	2006
	<b>US\$m</b>	US\$m
Deferred tax assets	<b>5,284</b>	3,241
Deferred tax liabilities	<b>(1,859)</b>	(1,096)
	<b>3,425</b>	2,145

The amount of temporary differences for which no deferred tax asset is recognised in the balance sheet is US\$923 million (2006: US\$1,067 million). Of this amount, US\$750 million (2006: US\$876 million) has no expiry date and US\$173 million (2006: US\$191 million) is scheduled to expire within 10 years.

Deferred tax is not recognised in respect of the Group's investments in subsidiaries, branches, associates and interests in joint ventures where remittance is not contemplated or where no additional tax is expected to arise. The aggregate amount of temporary differences associated with such investments is US\$29,947 million (2006: US\$22,424 million; 2005: US\$15,367 million).

**HSBC Holdings**

	Deferred tax asset/(liability)	
	<b>2007</b>	2006
	<b>US\$m</b>	US\$m

Temporary differences:

□ short-term timing differences	<b>1</b>	1
□ fair valued assets and liabilities	<b>(14)</b>	10
□ share-based payments	<b>20</b>	24
	<u>7</u>	<u>35</u>

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**Notes on the Financial Statements** (continued)

Notes 12, 13 and 14

**12 Dividends**

Dividends to shareholders of the parent company were as follows:

	2007			2006			2005		
	Per share US\$	Total US\$m	Settled in scrip US\$m	Per share US\$	Total US\$m	Settled in scrip US\$m	Per share US\$	Total US\$m	Settled in scrip US\$m
<b>Dividends declared on ordinary shares</b>									
In respect of previous year:									
□ fourth interim dividend	<b>0.360</b>	<b>4,161</b>	<b>2,116</b>	0.310	3,513	1,542	0.270	3,007	431
In respect of current year:									
□ first interim dividend	<b>0.170</b>	<b>1,986</b>	<b>712</b>	0.150	1,712	248	0.140	1,563	677
□ second interim dividend	<b>0.170</b>	<b>1,997</b>	<b>912</b>	0.150	1,724	515	0.140	1,574	311
□ third interim dividend	<b>0.170</b>	<b>2,007</b>	<b>614</b>	0.150	1,730	223	0.140	1,585	392
	<b>0.870</b>	<b>10,151</b>	<b>4,354</b>	0.760	8,679	2,528	0.690	7,729	1,811
<b>Quarterly dividends on preference share capital</b>									
March dividend	<b>15.50</b>	<b>22</b>		15.50	22		□	□	
June dividend	<b>15.50</b>	<b>23</b>		15.50	23		□	□	
September dividend	<b>15.50</b>	<b>22</b>		15.50	22		□	□	
December dividend	<b>15.50</b>	<b>23</b>		15.50	23		14.29	21	
	<b>62.00</b>	<b>90</b>		62.00	90		14.29	21	

The Directors declared after the end of the year a fourth interim dividend in respect of the financial year ended 31 December 2007 of US\$0.39 per ordinary share, a distribution of US\$4,628 million. The fourth interim dividend will be payable on 7 May 2008 to shareholders on the Register at the close of business on 25 March 2008. No liability is recorded in the financial statements in respect of the fourth interim dividend for 2007.

**13 Earnings per share**

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Basic earnings per ordinary share was calculated by dividing the earnings of US\$19,043 million (2006: US\$15,699 million; 2005: US\$15,060 million) by the weighted average number of ordinary shares, excluding own shares held, outstanding in 2007 of 11,545 million (2006: 11,210 million; 2005: 11,038 million).

	<b>2007</b>	2006	2005
	<b>US\$m</b>	US\$m	US\$m
Profit attributable to shareholders of the parent company	<b>19,133</b>	15,789	15,081
Dividend payable on preference shares classified as equity	<b>(90)</b>	(90)	(21)
	<u>          </u>	<u>          </u>	<u>          </u>
Profit attributable to the ordinary shareholders of the parent company	<b>19,043</b>	15,699	15,060
	<u>          </u>	<u>          </u>	<u>          </u>

Diluted earnings per ordinary share was calculated by dividing the basic earnings, which require no adjustment for the effects of dilutive potential ordinary shares (including share options outstanding not yet exercised), by the weighted average number of ordinary shares outstanding, excluding own shares held, plus the weighted average number of ordinary shares that would be issued on ordinary conversion of dilutive potential ordinary shares in 2007 of 11,661 million (2006: 11,320 million; 2005: 11,171 million). The effect of dilutive share options and share awards on the weighted average number of ordinary shares in issue was as follows:



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	Number of shares (millions)		
	2007	2006	2005
Average number of shares in issue	<b>11,545</b>	11,210	11,038
Dilutive share options and share awards	<b>116</b>	110	133
□ Savings-related Share Option Plan	<b>20</b>	27	22
□ Executive Share Option Scheme	<b>5</b>	10	11
□ Group Share Option Plan	<b>16</b>	28	14
□ Restricted and performance share awards	<b>67</b>	32	70
□ HSBC France share options	<b>5</b>	8	10
□ HSBC Finance share options	<b>3</b>	5	6
Average number of shares in issue assuming dilution	<b>11,661</b>	11,320	11,171

Of the total number of employee share options and share awards existing at 31 December 2007, 19 million were anti-dilutive (2006: 20 million; 2005: 121 million).

## 14 Segmental analysis

In the following segmental analysis, the benefit of shareholders' funds impacts the analysis only to the extent that these funds are actually allocated to businesses in the segment by way of intra-HSBC capital and funding structures.

By geographical region

Geographical information is classified by the location of the principal operations of the subsidiary, or, for The Hongkong and Shanghai Banking Corporation, HSBC Bank, HSBC Bank Middle East, HSBC Finance and HSBC Bank USA, by the location of the branch responsible for reporting the results or advancing the funds. Due to the nature of HSBC's structure, the analysis of profits shown below includes intra-HSBC items between geographical regions with the elimination shown in a separate column. The Rest of Asia-Pacific geographical segment includes the Middle East, India and Australasia. Shared costs are included in segments on the basis of the actual recharges made.

### Total assets

	At 31 December 2007		At 31 December 2006	
	US\$m	%	US\$m	%
Europe	<b>1,184,315</b>	<b>50.3</b>	828,701	44.6
Hong Kong	<b>332,691</b>	<b>14.1</b>	272,428	14.6
Rest of Asia-Pacific	<b>228,112</b>	<b>9.7</b>	167,668	9.0
North America	<b>510,092</b>	<b>21.7</b>	511,190	27.5
Latin America	<b>99,056</b>	<b>4.2</b>	80,771	4.3
	<b>2,354,266</b>	<b>100.0</b>	1,860,758	100.0

### Total liabilities

	At 31 December 2007		At 31 December 2006	
	US\$m	%	US\$m	%

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Europe	<b>1,126,508</b>	<b>50.7</b>	778,635	44.7
Hong Kong	<b>317,316</b>	<b>14.3</b>	258,028	14.8
Rest of Asia-Pacific	<b>210,499</b>	<b>9.5</b>	161,388	9.2
North America	<b>478,323</b>	<b>21.6</b>	477,310	27.3
Latin America	<b>86,204</b>	<b>3.9</b>	70,469	4.0
	<b>2,218,850</b>	<b>100.0</b>	1,745,830	100.0

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**Notes on the Financial Statements** (continued)

Notes 14

**Profit before tax**

Year ended 31 December 2007

	Europe US\$m	Hong Kong US\$m	Rest of Asia- Pacific US\$m	North America US\$m	Latin America US\$m	Intra- HSBC items US\$m	Total US\$m
Interest income	33,144	12,580	10,158	30,183	9,471	(3,177)	92,359
Interest expense	(25,398)	(7,097)	(6,015)	(15,336)	(3,895)	3,177	(54,564)
Net interest income	7,746	5,483	4,143	14,847	5,576	□	37,795
Fee income	10,973	3,860	2,709	6,733	2,647	(585)	26,337
Fee expense	(2,542)	(498)	(463)	(923)	(494)	585	(4,335)
Net fee income	8,431	3,362	2,246	5,810	2,153	□	22,002
Trading income/(expense) excluding net interest income .	3,003	1,270	1,202	(1,289)	272	□	4,458
Net interest income on trading activities	3,940	(28)	441	747	276	□	5,376
Net trading income	6,943	1,242	1,643	(542)	548	□	9,834
Net income from financial instruments designated at fair value	1,226	676	111	1,750	320	□	4,083
Gains less losses from financial investments	1,326	94	38	245	253	□	1,956
Gains arising from dilution of interests in associates	□	□	1,081	□	11	□	1,092
Dividend income	171	31	8	105	9	□	324
Net earned insurance premiums .	4,010	2,797	226	449	1,594	□	9,076
Other operating income	1,193	845	798	360	228	(1,985)	1,439
<b>Total operating income</b>	<b>31,046</b>	<b>14,530</b>	<b>10,294</b>	<b>23,024</b>	<b>10,692</b>	<b>(1,985)</b>	<b>87,601</b>
Net insurance claims incurred and movement in liabilities to policyholders	(3,479)	(3,208)	(253)	(241)	(1,427)	□	(8,608)
<b>Net operating income before loan impairment charges and other credit risk provisions</b>	<b>27,567</b> <b>(2,542)</b>	<b>11,322</b> <b>(231)</b>	<b>10,041</b> <b>(616)</b>	<b>22,783</b> <b>(12,156)</b>	<b>9,265</b> <b>(1,697)</b>	<b>(1,985)</b> <b>□</b>	<b>78,993</b> <b>(17,242)</b>

Loan impairment  
charges and other  
credit risk provisions

<b>Net operating income<sup>1</sup></b>	<b>25,025</b>	<b>11,091</b>	<b>9,425</b>	<b>10,627</b>	<b>7,568</b>	<b>(1,985)</b>	<b>61,751</b>
Total operating expenses (excluding depreciation and amortisation)	<b>(15,451)</b>	<b>(3,510)</b>	<b>(4,572)</b>	<b>(10,037)</b>	<b>(5,043)</b>	<b>1,985</b>	<b>(36,628)</b>
Depreciation of property, plant and equipment	<b>(848)</b>	<b>(180)</b>	<b>(159)</b>	<b>(317)</b>	<b>(210)</b>	□	<b>(1,714)</b>
Amortisation of intangible assets	<b>(226)</b>	<b>(90)</b>	<b>(33)</b>	<b>(202)</b>	<b>(149)</b>	□	<b>(700)</b>
<b>Total operating expenses</b>	<b>(16,525)</b>	<b>(3,780)</b>	<b>(4,764)</b>	<b>(10,556)</b>	<b>(5,402)</b>	<b>1,985</b>	<b>(39,042)</b>
<b>Operating profit</b>							