

HSBC HOLDINGS PLC
Form 20-F
March 08, 2011

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As filed with the Securities and Exchange Commission on March 8, 2011.

**SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 20-F**

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

Or

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

For the fiscal year ended December 31, 2010

Or

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

Or

**o SHELL COMPANY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934**

Date of event requiring this shell company report _____

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

United Kingdom

(Translation of Registrant's name into English)

(Jurisdiction of incorporation or organisation)

**8 Canada Square
London E14 5HQ
United Kingdom**

(Address of principal executive offices)

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United Kingdom**

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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**

American Depositary Shares, each representing 5 Ordinary Shares of nominal value US\$0.50 each.
6.20% Non-Cumulative Dollar Preference Shares, Series A

Bermuda Stock Exchange
New York Stock Exchange*
New York Stock Exchange

New York Stock Exchange*

New York Stock Exchange

American Depositary Shares, each representing one-fortieth of a Share of 6.20% Non-Cumulative Dollar Preference Shares, Series A

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

6.8% Subordinated Notes Due 2038

New York Stock Exchange

8.125% Perpetual Subordinated Capital Securities Exchangeable at the Issuer's Option into Non-Cumulative Dollar Preference Shares

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 close of the period covered by the annual report:

Ordinary Shares, nominal value US\$0.50 each 17,686,155,902

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

(Do not check if a smaller reporting company)

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

U.S. 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.

Item 17 Item 18

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 Depositary Shares.

HSBC HOLDINGS PLC
Annual Report and Accounts 2010

Certain defined terms

Unless the context requires otherwise, HSBC Holdings means HSBC Holdings plc and HSBC, the Group, we, us and our refers to 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. The abbreviations US\$m and US\$bn represent millions and billions (thousands of millions) of US dollars, respectively.

Financial statements

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 issued by the International Accounting Standards Board (IASB) and as endorsed by the European Union (EU). EU-endorsed IFRSs may differ from IFRSs as issued by the IASB if, at any point in time, new or amended IFRSs have not been endorsed by the EU. At 31 December 2010, there were no unendorsed standards effective for the year ended 31 December 2010 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 2010 are prepared in accordance with IFRSs as issued by the IASB.

We use the US dollar as our presentation currency because the US dollar and currencies linked to it form the major currency bloc in which we transact and fund our 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 14), eliminating the impact of fair value movements in respect of credit spread changes on HSBC's own debt and adjusting for the effects of acquisitions and disposals. A reconciliation of reported and underlying profit before tax is presented on page 15.

Report of the Directors

The information set out in the Report of the Directors on pages 2 to 219 does not constitute the directors' report included in the Company's Annual Report and Accounts for the year ended 31 December 2010 under Section 415 of the Companies Act 2006 as it includes certain supplementary information and explanations.

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HSBC HOLDINGS PLC

Report of the Directors: Overview

Overview

Headquartered in London, HSBC is one of the world's largest banking and financial services organisations and one of the industry's most valuable brands. We provide a comprehensive range of financial services to around 95 million customers through two customer groups, Personal Financial Services (including consumer finance), and Commercial Banking, and two global businesses, Global Banking and Markets, and Global Private Banking.

Our international network covers 87 countries and territories in six geographical regions; Europe, Hong Kong, Rest of Asia-Pacific, the Middle East, 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 over 221,000 shareholders in 127 countries and territories.

Highlights

Pre-tax profit more than doubled to US\$19bn on a reported basis.

Underlying pre-tax profit up by almost US\$5bn or 36% to US\$18.4bn.

Profitable in every customer group and region, including North America, for the first time since 2006.

Dividends declared in respect of 2010 totalled US\$6.3bn, or US\$0.36 per ordinary share, with a fourth interim dividend for 2010 of US\$0.12 per ordinary share.

Continued capital generation – core tier 1 ratio increased to 10.5% from 9.4%.

Customer lending up 8% to US\$958bn; deposits up 7% to US\$1.2 trillion on an underlying basis.

Cover theme

An evening view of the Central Elevated Walkway in Hong Kong's business district. Used by tens of thousands of commuters every day, this walkway forms a vital artery through the heart of Asia's pre-eminent financial centre, which hosts over 190 banks and deposit-taking companies from all over the world.

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HSBC HOLDINGS PLC

Report of the Directors: Overview (continued)**Financial highlights****For the year**

Profit before taxation	Underlying profit before taxation	Total operating income
US\$19,037m <i>up 169%</i>	US\$18,366m <i>up 36%</i>	US\$80,014m <i>up 2%</i>

2009: US\$7,079m	2009: US\$13,482m	2009: US\$78,631m
2008: US\$9,307m		2008: US\$88,571m

Net operating income before loan impairment charges and other credit risk provisions

US\$68,247m *up 3%*

2009: US\$66,181m
2008: US\$81,682m

Profit attributable to shareholders of the parent company

US\$13,159m *up 126%*

2009: US\$5,834m
2008: US\$5,728m

Earnings per share and dividends per share**Earnings per share**US\$0.73 *up 115%*

2009: US\$0.34
2008: US\$0.41

Dividends per share¹

US\$0.34

2009: US\$0.34
2008: US\$0.93

At the year-end**Loans and advances to customers**US\$958bn *up 7%*

2009: US\$896bn

Customer accountsUS\$1,228bn *up 6%*

2009: US\$1,159bn

Ratio of customer advances to customer accounts

78.1%

2009: 77.3%

2008: US\$933bn	2008: US\$1,115bn	2008: 83.6%
Total equity	Average total shareholders equity to average total assets	Risk-weighted assets
US\$155bn <i>up 14%</i>	5.5%	US\$1,103bn <i>down 3%</i>
2009: US\$136bn	2009: 4.7%	2009: US\$1,133bn
2008: US\$100bn	2008: 4.9%	2008: US\$1,148bn

Capital ratios

Core tier 1 ratio	Tier 1 ratio	Total capital ratio
10.5%	12.1%	15.2%
2009: 9.4%	2009: 10.8%	2009: 13.7%
2008: 7.0%	2008: 8.3%	2008: 11.4%

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HSBC HOLDINGS PLC

Report of the Directors: Overview (continued)**Performance ratios**

Credit coverage ratios

Loan impairment charges to total operating income	Loan impairment charges to average gross customer advances	Total impairment allowances to impaired loans at year-end
16.9%	1.5%	71.6%
2009: 31.7%	2009: 2.8%	2009: 83.2%
2008: 27.2%	2008: 2.5%	2008: 94.3%

Return ratios

Return on average invested capital²	Return on average shareholders equity³	Post-tax return on average total assets	Post-tax return on average risk-weighted assets
8.7%	9.5%	0.6%	1.3%
2009: 4.1%	2009: 5.1%	2009: 0.3%	2009: 0.6%
2008: 4.0%	2008: 4.7%	2008: 0.3%	2008: 0.6%

Efficiency and revenue mix ratios

Cost efficiency ratio⁴	Net interest income to total operating income	Net fee income to total operating income	Net trading income to total operating income
55.2%	49.3%	21.7%	9.0%
2009: 52.0%	2009: 51.8%	2009: 22.5%	2009: 12.5%
2008: 60.1%	2008: 48.1%	2008: 22.6%	2008: 7.4%

Share information at the year-end

Closing market price				
US\$0.50 ordinary shares in issue	Market capitalisation	London	Hong Kong	American Depositary Share ⁵

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17,686m	US\$180bn	£6.51	HK\$79.70	US\$51.04
2009: 17,408m	2009: US\$199bn	2009: £7.09	2009: HK\$89.40	2009: US\$57.09
2008: 12,105m	2008: US\$114bn	2008: £5.77	2008: HK\$67.81	2008: US\$44.15

Total shareholder return⁶

	Over 1 year	Over 3 years	Over 5 years
To 31 December 2010	95.3	103.4	103.4
Benchmarks:			
FTSE 100	112.6	102.8	126.3
MSCI World	115.9	111.0	127.0
MSCI Banks	103.7	81.9	79.0

For footnotes, see page 83.

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Report of the Directors: Overview (continued)

Cautionary statement regarding forward-looking statements

The *Annual Report and Accounts 2010* contains certain forward-looking statements with respect to HSBC's financial condition, results of operations and business.

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*, 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 US 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 include, but are not limited to:

changes in general economic conditions in the markets in which we operate, such as continuing or deepening recessions and fluctuations in employment beyond those factored into consensus forecasts; changes in foreign exchange rates and interest rates; volatility in equity markets; lack of liquidity in wholesale funding markets; illiquidity and downward price pressure in national real estate markets; adverse changes in central banks' policies with respect to the provision of liquidity support to financial markets; heightened market concerns over sovereign creditworthiness in over-indebted countries; adverse changes in the funding status of public or private defined benefit pensions; and consumer perception as to the continuing availability of credit and price competition in the market segments we serve;

changes in government policy and regulation, including the monetary, interest rate and other policies of central banks and other regulatory authorities; initiatives to change the size, scope of activities and interconnectedness of financial institutions in connection with the implementation of stricter regulation of financial institutions in key markets worldwide; revised capital and liquidity benchmarks which could serve to deleverage bank balance sheets and lower returns available from the current business model and portfolio mix; imposition of levies or taxes designed to change business mix and risk appetite; the practices, pricing or responsibilities of financial institutions serving their consumer markets; expropriation, nationalisation, confiscation of assets and changes in legislation relating to foreign ownership; changes in bankruptcy legislation in the principal markets in which we operate and the consequences thereof; general changes in government policy that may significantly influence investor decisions; extraordinary government actions as a result of current market turmoil; other unfavourable political or diplomatic developments producing social instability or legal uncertainty which in turn may affect demand for our products and services; the costs, effects and outcomes of product regulatory reviews, actions or litigation, including any additional compliance requirements; and the effects of competition in the markets where we operate including increased competition from non-bank financial services companies, including securities firms; and

factors specific to HSBC, including our success in adequately identifying the risks we face, 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, our ability through stress testing and other techniques to prepare for events that cannot be captured by the statistical models it uses; and our success in addressing operational, legal and regulatory, and litigation challenges.

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Report of the Directors: Overview (continued)

Group Chairman's Statement

When I took on the role of Chairman less than 90 days ago, I was acutely aware of the challenges facing our industry. I was conscious too of the need to demonstrate to all of our stakeholders that HSBC understands the responsibilities that accompany the systemic significance which continued success has built for HSBC in many of the markets in which we operate, not least those in Asia, given their historical significance to the Group. 145 years after we were founded, Hong Kong and the rest of Asia remain at the heart of HSBC's strength and identity and our commitment to the region is unwavering.

I fully acknowledge that our scale, the trust that our depositors place in us and our relevance to our personal and corporate clients for their financing, banking, investment and risk management needs all depend upon our maintaining our reputation and our integrity.

I also understand how important it is for you, our shareholders, that HSBC builds sustainable long-term value that is reflected through the share price and rebuilds, as quickly as competing regulatory demands allow, the dividend that was reduced during the financial crisis.

I firmly believe that HSBC has the people, the financial strength and the organisational structure best able to deliver all of the above and it is a privilege to have the opportunity to serve as Group Chairman as we enter a fresh chapter in our history.

Before I go any further, I want to pay tribute to both Stephen Green and Michael Geoghegan, who stepped down at the end of last year from their roles as Group Chairman and Group Chief Executive after, respectively, 28 and 37 years' service to HSBC. It fell to them to be at the helm as HSBC navigated its way through the worst financial crisis since the 1930s. Mike led from the front in addressing the problems in our consumer finance subsidiary in the United States and in reshaping HSBC's organisational structure and operational practices in order to better and more efficiently serve an increasingly interconnected world. Stephen's personal reputation for integrity and probity stood out and distinguished HSBC during a period of intense disaffection with the banking industry. For their contribution over many years we owe them a deep debt of gratitude and wish them both well.

Our performance in 2010

The Group Chief Executive's Business Review sets out clearly how HSBC delivered a much improved balance of profits in 2010. It is reassuring to see our Personal Financial Services businesses returning to profitability in aggregate and Commercial Banking growing significantly, largely in emerging markets. These achievements augmented another year of strong performance in Global Banking and Markets.

Earnings per share improved strongly, rising by 115% to reach US\$0.73 per share.

The Group's capital position also strengthened with the core tier 1 ratio, the ratio most favoured by regulators as it comprises equity capital after regulatory adjustments and deductions, increasing from 9.4% to 10.5%, largely due to profit retention throughout the year.

As a consequence of this strong capital generation, together with greater clarity on the direction of regulatory reform of capital requirements and an improving economic backdrop in the developed world particularly in the United States the Board has approved increases in both the final dividend payment in respect of 2010 and the planned quarterly dividends for 2011. The final dividend for 2010, payable on 5 May 2011 to shareholders on the register on 17 March 2011, will be 12 cents per ordinary share, up from 10 cents at the same point last year. For the remainder of 2011 we plan to pay quarterly dividends of nine cents for each of the first three quarters compared with eight cents in respect of the equivalent quarters of 2010.

A new leadership team

We enter 2011 with a new leadership team, but only in the sense of changed roles. Everyone has worked together over many years and there is immense experience to draw on both from within HSBC and from earlier careers at peer organisations. Stuart Gulliver is leading the management team as Group Chief Executive. His clear objective is to deliver

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Report of the Directors: Overview (continued)

sustainable long-term value for shareholders consistently in a manner that maintains the confidence of all other key stakeholders in our businesses including depositors, counterparties, long-term creditors, customers, employees, regulators and governments. His review on pages 7 to 9 gives an insight into his immediate priorities.

Everything we do is governed by the imperative of upholding HSBC's corporate reputation and character at the highest level and adding further strength to our brand; we deeply regret that a number of weaknesses in regulatory compliance were highlighted in 2010 and we are resolved to remedy these and reinforce the high standards we demand of ourselves.

For my part, I shall be focusing on engaging at the highest level in the regulatory reform debates that will, in large part, shape our future. I shall also lead the Board in the stewardship and review of performance of our financial and human resources.

In the interest of full transparency, we have today published on our website the respective roles and responsibilities of the Group Chairman, the Deputy Chairman and Senior Independent Director and the Group Chief Executive.

Board changes

I have already paid tribute to the contributions of Stephen Green and Michael Geoghegan. Vincent Cheng has indicated that he will step down at the next AGM and on behalf of the Board I want to thank him for his immense contribution in many roles over 33 years. Vincent will retain an association with the Group by taking on an advisory role to the Group Chief Executive on regional matters. Laura Cha will join the Board on 1 March; Laura has been Deputy Chair of The Hongkong and Shanghai Banking Corporation Limited for four years and brings a wealth of experience of China; fuller details of her background and experience are set out in the Directors' Report.

Regulatory update

There was much progress made during 2010 on the regulatory reform agenda. Although there is still a great deal to do, the shape of capital requirements was broadly clarified and an implementation timetable stretching out to 2019 was agreed to allow time for the industry to adjust progressively. A minimum common equity tier 1 ratio of 7%, including a capital conservation buffer, has been agreed. HSBC already meets this threshold requirement. The Group Chief Executive's Business Review addresses how these revised requirements will impact our targeted return on equity.

During 2011, the debate will be dominated by consideration of the calibration of minimum liquidity standards. Although it is clear that liquidity and funding weaknesses were key elements contributing to the crisis, HSBC agrees with the industry consensus that the revised requirements in these areas are overly conservative and could lead to unnecessary deleveraging at a time of fragile economic recovery in much of the developed world. It will be a near impossibility for the industry to expand business lending at the same time as increasing the amount of deposits deployed in government bonds while, for many banks but not HSBC, reducing dependency on central bank liquidity support arrangements. It is to be hoped that the observation period, which starts this year and precedes the formal introduction of the new requirements, will inform a recalibration of these minimum liquidity standards.

A second debate of importance to HSBC's shareholders in 2011 will concern the designation of Systemically Important Financial Institutions (SIFIs). Consideration is being given in the regulatory community to mandating higher capital requirements, together with more intense supervision, for institutions classified as SIFIs. We agree with heightened supervision but it is not clear that the reduced shareholder returns that would follow the imposition of incremental capital would be compensated for by improved stability. Classification as a SIFI with a requirement to hold incremental capital would, however, probably lead others to favour SIFIs as counterparties, and may therefore have the unintended consequence of further concentrating the industry.

HSBC's position is that systemic importance should not be determined by size alone. It is clear, however, that, on almost any basis, HSBC would be classified as systemically important. For this reason we are engaging fully in the

debate around the consequences of designation as a SIFI. In particular, we draw attention to the benefits of our corporate organisation through separate subsidiaries in mitigation against the imposition of incremental capital for SIFIs based on size alone.

In October 2010, the UK government confirmed its intention to raise the sum of £2.5bn (US\$3.9bn) through a levy on bank balance sheets, and recently announced it will accelerate the full impact of this levy to 2011. We take no issue with the right of the UK government to raise a levy on the banking industry, particularly when having had to risk taxpayers' money to rescue a number of important UK institutions. However, as the proposed levy is to

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Report of the Directors: Overview (continued)

be applied to the consolidated balance sheet, it applies beyond the legal boundary of the domestic institution to include overseas operations conducted through separately capitalised subsidiaries. This therefore constitutes an additional cost of basing a growing multinational banking group in the UK.

We intend to clarify in each set of results going forward the impact of the levy, split between UK and overseas operations, and Stuart Gulliver covers this in more detail in his review. We regard the levy, which is not tax deductible, as akin to a distribution of profits. For this reason, we intend to add to future shareholder dividends that would otherwise be paid, any amount saved in the event that the levy is restructured or relieved in due course.

The role of banks in society

The recent crisis has caused a proper introspection as to the role that banks play in society and at HSBC we welcome this. Banking is not simply about money. It is about helping individuals and organisations within society to meet personal and corporate objectives by facilitating access to financial capital and protecting value for those who make capital available. Payment mechanisms, the provision of long-term credit, trade finance, hedging and other risk management products, deposit, investment and retirement services are but a few of the activities through which banking groups contribute to today's financial system. Society cannot function without an effective financial system that delivers value to those it serves at an intermediation cost that is proportionate to the value created. Somehow, many participants and not just banks, lost sight of this basic principle in the run-up to the recent financial crisis and the consequences for all have, inevitably, been far reaching. There is no doubt that the scale of regulatory reform will bring many challenges, but it will also open new opportunities.

At HSBC, we shall not forget what happened to precipitate the scale of reform now underway. Although the financial turmoil arising from the events of 2007-2008 has largely moderated, in large part as a result of co-ordinated government action and support to the financial system, we enter 2011 with humility, ready to apply right across HSBC all of the lessons learned, notwithstanding that HSBC itself neither sought nor received support from any government.

Society has a right to ask if banks get it. At HSBC, we do and we are focused on embedding the necessary changes in our business model for long-term sustainable value creation. But we also do not forget that value creation depends upon HSBC recruiting, training and retaining the right talent in order to manage the risks we accept through intermediating customer flows; design solutions to address complex financial problems; build enduring relationships with core customers; build confidence in the Group's financial strength; and create the strategic options that offer the next generation fresh opportunities to continue building sustainable value.

In this globalised world, there is intense competition for the best people and, given our long history within and connections into the faster-growing developing markets, our best people are highly marketable. It would be irresponsible to allow our comparative advantages to wither by ignoring the market forces that exist around compensation, even though we understand how sensitive this subject is. Reform in this area can only be achieved if there is concerted international agreement on limiting the quantum of pay as well as harmonising pay structures but there appears to be no appetite to take the initiative on this. Our duty to shareholders is to build sustainable value in the economic and competitive environment in which we operate and our principal resource for achieving this is human talent. Under the governance of the Board, we will continue to operate and apply remuneration policies and practices that take full recognition of best practice and are aligned with the long-term interests of shareholders.

HSBC's people

Finally, I want to pay tribute to my 307,000 colleagues. So many of HSBC's people have exemplified commitment and endeavour again in 2010, helping our customers and clients to meet their financial objectives while taking on the additional burden of preparing for regulatory change. This has been done against a backdrop of continuing broad-based fiscal support to many economies, with public opinion consistently and highly critical of our industry. As

I look forward, it is the combination of the capabilities of HSBC's people, their determination to do the right thing for our customers and their deep sense of responsibility to the communities they serve that makes me confident that HSBC will play a leading role in rebuilding the trust that our industry has lost and, by doing so, will build sustainable value for you, our shareholders.

D J Flint, *Group Chairman*

28 February 2011

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HSBC HOLDINGS PLC

Report of the Directors: Overview (continued)**Group Chief Executive's
Business Review**

Underlying financial performance continued to improve in 2010 and shareholders continued to benefit from HSBC's universal banking model. All regions and customer groups were profitable, as Personal Financial Services and North America returned to profit. Commercial Banking made an increased contribution to underlying earnings and Global Banking and Markets also remained strongly profitable, albeit behind 2009's record performance, reflecting a well-balanced and diversified business.

Credit experience continued to improve, as a result of a stronger global economy and our actions to reduce balance sheet risk. As a globally-connected bank with a growing presence across the world's faster-growing regions, HSBC also benefited from higher trade volumes and strong momentum in emerging economies, especially in Asia. Asia contributed the largest proportion to underlying pre-tax profits, while the contributions made by Latin America and the Middle East also increased. Together with our conservative management of the balance sheet, this improved performance allowed us to concentrate on serving our customers and to further strengthen our capital position.

Group performance headlines¹

Profit before tax improved year on year. On a reported basis, profits increased by nearly US\$12bn from US\$7.1bn to US\$19bn. On an underlying basis, profits increased by 36%, or almost US\$5bn, from US\$13.5bn to US\$18.4bn.

- 1 *All figures are discussed on a reported basis and all references to profits are profits before tax unless otherwise stated.*

In a period of sustained low interest rates, revenues remained constrained, reflecting four principal factors: reducing loan balances in our US business; lower trading income in Global Banking and Markets resulting from lower client activity; adverse fair value movements on non-qualifying hedges; and a reduced contribution from Balance Sheet Management in line with earlier guidance.

Strong asset growth in Commercial Banking, particularly in Asia, higher trade-related revenues generally, and expansion of our wealth management business, again most notably in Asia, partially offset these revenue pressures.

Loan impairment charges reduced by almost half to US\$14.0bn. All regions and customer groups improved. The US experienced the greatest improvement, largely in the cards and consumer finance portfolios. Loan impairment charges also declined significantly in Latin America and the Middle East.

In Global Banking and Markets, loan impairment charges fell significantly, notably in Europe as economic conditions improved. Credit risk provisions reduced by US\$1bn to US\$0.4bn in the available-for-sale asset-backed-securities portfolios due to a slowing in the rate of anticipated losses on underlying assets, in line with previous guidance. The associated available for sale reserve declined to US\$6.4bn from US\$12.2bn.

The cost efficiency ratio rose to 55.2%, which is above our target range and unacceptable to me. The causes were constrained revenues and, in part, investment in strategic growth initiatives across the business together with higher staff costs. It additionally reflected one-off payroll taxes of US\$0.3bn paid in 2010 in respect of the previous year and a pension accounting credit of US\$0.5bn in 2009 and US\$0.1bn in 2010. However, it is also clear that we need to re-engineer the business to remove inefficiencies.

Return on average total shareholders' equity rose from 5.1% to 9.5%, reflecting increased profit generation during the year.

HSBC continued to grow its capital base and strengthen its capital ratios further. The core tier 1 ratio increased from 9.4% to 10.5%, as a result of capital generation and lower risk weighted assets.

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HSBC HOLDINGS PLC

Report of the Directors: Overview (continued)

Total loans and advances to customers increased by 7% to US\$958bn while deposits rose by 6% to US\$1.2 trillion.

Impact of the evolving regulatory environment on the business

Much of the detail around the potential impact of change for banks remains uncertain. However, analysis of what we know confirms that our ability to generate capital and manage our risk-weighted assets positions HSBC strongly and competitively within the industry as the pace of change intensifies.

HSBC fully supports the rationale of the Basel III proposals which require banks to hold more capital. This is absolutely core to ensuring that governments and taxpayers are better protected in future than they have been in the past.

Certain aspects of the Basel III rules remain uncertain as to interpretation and application by national regulators. Notably, this includes any capital requirements which may be imposed on the Group over the implementation period in respect of the countercyclical capital buffer and any additional regulatory requirements for SIFIs. However, we believe that ultimately the level for the common equity tier 1 ratio of the Group may lie in the range 9.5 to 10.5%. This exceeds the minimum requirement for common equity tier 1 capital plus the capital conservation buffer.

We have estimated the pro forma common equity tier 1 ratio of the Group based on our interpretation of the new Basel III rules as they will apply from 1 January 2019, based on the position of the Group at year-end 2010. The rules will be phased in from 2013 with a gradual impact and we have estimated that their full application, on a proforma basis, would result in a common equity tier 1 ratio which is lower than the Basel II core tier 1 ratio by some 250-300 basis points. The changes relate to increased capital deductions, new regulatory adjustments and increases in risk-weighted assets. However, as the changes will progressively take effect over six years leading up to 2019 and as HSBC has a strong track record of capital generation and actively manages its risk-weighted assets, we are confident in our ability to mitigate the effect of the new rules before they come into force.

Last year, HSBC committed to reviewing its target shareholder return on equity once the effects of new regulation became clearer. Now that we have better visibility on the impact of increased capital requirements, we believe that higher costs of the evolving regulatory framework will, all other things being equal, depress returns for shareholders of banks. We will therefore target a return on average shareholders' equity of 12-15% in the future.

As Group Chief Executive, it is right that, in managing the business and developing Group strategy, my principal office should be in Hong Kong – a global financial hub of growing importance at the centre of HSBC's strategically most important region. However, the company is headquartered in London and we hope to remain there. London's pre-eminence as an international financial services centre is widely recognised and well-deserved and reflects successful government policy over decades to build that position. It is therefore important to us that the UK's competitive position is protected and sustained. Appropriate supervision is an important part of the larger equation. Policymakers should continue to legislate and regulate, but they must not destroy London's competitive position in the process.

As the Group Chairman has outlined, new legislation is expected to be enacted in the UK, effective from the start of 2011, one curious consequence of which is an explicit incremental cost of being headquartered in the UK for any global bank. Had this been applied for 2010, this annual charge would have amounted to approximately US\$0.6bn in HSBC's case. Moreover, the overseas balance sheet would account for the majority of the annual charge, with the UK balance sheet accounting for approximately one third of the total.

Outlook

We have been closely watching events unfold in parts of the Middle East and North Africa. Our primary concern is for the security of our 12,000 staff across the region and we continue to work to ensure their safety. We have also activated robust continuity plans so that we can also stay open for business and support the needs of our customers. As a strongly capitalised global bank, HSBC's financial performance has not been materially affected by events to date. HSBC has been present in the Middle East for more than 50 years and we remain absolutely committed to its future. We also believe that the region's economies have a number of structural strengths which leave us positive on the longer-term outlook.

In the short term, risks to global growth remain, not least from an elevated oil price. We therefore expect cyclical volatility to continue including in emerging markets and progress is unlikely to be linear. In the longer term, we believe that growth

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Report of the Directors: Overview (continued)

rates in many Western markets will continue to significantly underperform those of the emerging world. Emerging markets are no longer simply leading the recovery from a Western crisis; the growth gap has become a sustained secular trend.

The global economy's structural position also requires fundamental readjustment. Many Western economies must still deal with a large overhang of household and government debt and weak growth and high unemployment will make this a slow and painful process. As faster-growing nations seek to limit the effect of Western monetary policy on their own economies, we cannot discount the risk of increased tension over exchange rate and trade issues.

HSBC's balance sheet remains strongly positioned to benefit from future interest rate rises. We are realistic that, in many developed countries at least, historically low rates may continue to constrain income growth in the near-term. Nevertheless, maintaining a conservative liquidity position is core to our proposition and to our funding strength. In our risk appetite statement approved by the Board we have set a maximum advances-to-deposits ratio for the Group of 90%. This underlines our continuing commitment to a high level of liquidity and reflects our philosophy that HSBC should not be reliant on wholesale markets for funding. Even with a ratio currently slightly below 80%, we have capacity for further lending growth.

In the short-term, we expect the benefits of asset growth achieved in 2010 to continue to flow into revenues. In the medium-term, we will continue to target growth in the most strategically attractive markets for HSBC and build our capabilities in connectivity, one of our distinctive strengths as a globally-connected bank.

At the same time, with demand in many developed markets constrained and interest spreads remaining compressed, we fully recognise the importance of ever more robust cost management discipline and the need to continue re-engineering the business to improve efficiency.

Furthermore, capital is becoming a scarcer resource and, as a new regulatory environment evolves, I am committed to making capital allocation a more disciplined and rigorous process at HSBC in order to drive the correct investment decisions for the future.

We will talk more to investors about each of these initiatives later in the spring. However, as a result of this focus, we are committed to delivering a cost efficiency ratio and a return on average shareholders' equity within our published target range.

We also recognise the importance of reliable dividend income for our shareholders and I believe it should be possible to benchmark a payout ratio of between 40-60% of attributable profits under normal market conditions.

In closing, I would like to acknowledge the huge contribution that my predecessor, Mike Geoghegan, made to HSBC in his five years as Group Chief Executive – not least during 2010 – and I wish him well for the future.

Finally, I am pleased to report that we have had a good start to the year, with continued momentum in lending, mainly in emerging markets and in respect of global trade.

S T Gulliver, *Group Chief Executive*

28 February 2011

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HSBC HOLDINGS PLC

Report of the Directors: Overview (continued)

Principal activities

HSBC is one of the largest banking and financial services organisations in the world, with a market capitalisation of US\$180bn at 31 December 2010. We are headquartered in London.

As The world's local bank, we combine the largest global emerging markets banking business and a uniquely cosmopolitan customer base with an extensive international network and substantial financial strength.

HSBC operates through long-established businesses and has an international network of some 7,500 offices in 87 countries and territories in six geographical regions; Europe, Hong Kong, Rest of Asia-Pacific, the Middle East, North America and Latin America.

Our products and services are delivered through two customer groups, Personal Financial Services (PFS) and Commercial Banking (CMB), and two global businesses, Global Banking and Markets (GB&M), and Global Private Banking (GPB). PFS incorporates the Group's consumer finance businesses, the largest of which is HSBC Finance Corporation (HSBC Finance).

Taken together, our five largest customers do not account for more than 1% of our income.

We have contractual and other arrangements with numerous third parties in support of our business activities. None of the arrangements is individually considered to be essential to the business of the Group.

There were no significant acquisitions during the year (for details of acquisitions see page 340).

Strategic direction

Our objective is to deliver sustainable long-term value to shareholders through consistent earnings and superior risk-adjusted returns.

Our strategy is to be the world's leading international bank, by:

leveraging the HSBC brand and our network of businesses which covers the world's most relevant geographies.

This network provides access to the world's fastest growing economies, for example Greater China. We serve companies as they grow and become more international and individuals as they become wealthier and require more sophisticated financial services, such as wealth management; and

competing as a universal bank across the full financial services spectrum only where we have scale and can achieve appropriate returns. This implies building scale in attractive geographical regions and businesses where we can be competitive and reviewing businesses which do not meet our financial hurdles.

The strategy reflects the key trends which are shaping the global economy. In particular, we recognise that over the long term, developing markets are growing faster than mature economies and connectivity continues to increase as world trade is expanding at a greater rate than gross domestic product, generating increased demand for financial services. We are, therefore, continuing to direct incremental investment primarily to the faster growing markets and client segments which have international connectivity. In order to deliver this strategy we pursue a series of initiatives, reflected in the Group's key performance indicators:

enhance efficiency by taking full advantage of local, regional and global economies of scale, in particular by adopting a common systems architecture wherever possible;

maintain capital strength and a strong liquidity position. Capital and liquidity are critical for our strategy and are the foundation of decisions about the pace and direction of investment; and

align objectives and incentives to motivate and reward staff for being fully engaged in delivering the strategy.

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HSBC HOLDINGS PLC

Report of the Directors: Overview (continued)

Top and emerging risks

All of our activities involve, to varying degrees, the measurement, evaluation, acceptance and management of risk or combinations of risks. We classify risks as top and emerging. A top risk is a current, visible risk with the potential to have a material effect on our financial results or our reputation. An emerging risk is one which has large unknown components which could have a material impact on our long-term strategy. Top and emerging risks are viewed as falling under the following four broad categories:

challenges to our business operations;

challenges to our governance and internal control systems;

macro-economic and geopolitical risk; and

macro-prudential and regulatory risks to our business model.

The top and emerging risks are summarised below:

Challenges to our business operations

Challenges to our operating model in an economic downturn (in developed countries) and rapid growth (in emerging markets)

Internet crime and fraud

Challenges to our governance and internal control systems

Level of change creating operational complexity

Information security risk

Macro-economic and geopolitical risk

Potential emerging markets asset bubble

Increased geopolitical risk in Asia-Pacific and Middle East regions

Macro-prudential and regulatory risks to our business model

Regulatory change impacting our business model and Group profitability

Regulatory requirements affecting conduct of business

Key performance indicators

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

Following a review of our high-level key performance indicators (KPI s), the GMB decided to make the following changes to the Group's published indicators in order to restrict their number to those which most accurately reflect its management priorities. The Group now has seven financial and three non-financial KPIs.

the ratio of advances to core funding has been added to highlight the relationship between loans and advances to customers and core customer deposits in our principal banking entities;

tier 1 capital has been added as a primary indicator of the strength of our capital base, and its ability to support the growth of the business and meet regulatory capital requirements;

revenue growth, revenue mix factors and credit performance as measured by risk-adjusted margin have been replaced with risk-adjusted revenue growth;

the GMB will prioritise return on average total shareholders' equity in place of return on average invested capital, which has therefore been excluded; and

customer transactions processed and percentage of information technology (IT) services meeting targets form part of management information within our IT function. However, the GMB decided that these measures, which we have previously disclosed, were not appropriate proxies for assessing efficiencies and progress with implementing standard systems architecture.

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Report of the Directors: Overview (continued)

Strategic objectives

Deliver consistent earnings and superior risk-adjusted returns

Risk-adjusted revenue growth
(2010: underlying growth 15%)

Basic earnings per ordinary share

Dividends per share growth

Measure: (percentage) increase in reported net operating income after loan impairment and other credit risk charges since last year.

Measure: (US\$) level of basic earnings generated per ordinary share.

Measure: (percentage) increase in dividends per share since last year, based on dividends paid in respect of the year to which the dividend relates.

Key Performance Indicators

Target: to deliver consistent growth in risk adjusted revenues.

Target: to deliver consistent growth in basic earnings per share.

Target: to deliver sustained dividend per share growth.

Outcome: reported risk-adjusted revenue increased, primarily due to a reversal of adverse movements in previous years on the fair value of own debt designated at fair value and lower loan impairment charges. The latter also drove the increase in underlying risk-adjusted revenue.

Outcome: Earnings per share (EPS) increased in 2010, reflecting significantly lower adverse movements on the fair value of own debt due to credit spreads and lower loan impairment charges, which resulted in an increase in reported profit.

Outcome: dividends per share increased by 5.9%.

Strategic objectives

Enhance efficiency using economies of scale
Cost efficiency

Motivate staff to deliver strategy
Employee engagement

Key Performance Indicators

Measure: (percentage) total operating expenses divided by net operating income

Measure: (percentage) measure of employee s emotional and rational

before loan impairment and other credit risk provisions.

attachment to HSBC, a combination of advocacy, satisfaction, commitment and pride.

Target: to be between 48% and 52%, a range within which business is expected to remain to accommodate both returns to shareholders and the need for continued investment in support of future business growth.

Target: to achieve a 72% global rating in 2010, with progressive improvement to best in class by 2011.

Outcome: the ratio was outside the target range in part due to one-off costs, but also increased investment in operational infrastructure and strategic initiatives.

Outcome: 68%, mirroring the fall in global best in class but remaining well above the financial services average.

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HSBC HOLDINGS PLC

Report of the Directors: Overview (continued)

Maintain capital strength and strong liquidity			Strategic objectives
Return on average total shareholders equity	Tier 1 capital	Advances to core funding ratio	
<p>Measure: (percentage) profit attributable to ordinary shareholders divided by average total shareholders equity.</p> <p>Target: to maintain a return in the medium term of between 15% and 19%. In 2011, we intend to replace the target with one in the 12% to 15% range over the normal cycle.</p> <p>Outcome: return on equity was below the target range, but 4.4 percentage points higher than in 2009.</p>	<p>Measure: component of regulatory capital comprising core tier 1 and other tier 1 capital.</p> <p>Target: to maintain a strong capital base to support the development of the business and meet regulatory capital requirements at all times.</p> <p>Outcome: the increase in tier 1 capital to 12.1% reflected the contribution of profit to capital, the issue of hybrid capital securities during the year and careful management of RWAs.</p>	<p>Measure: current loans and advances to customers as a percentage of the total of core customer deposits and term funding with a remaining term to maturity in excess of one year.</p> <p>Target: to maintain an advances to core funding ratio below limits set for each entity.</p> <p>Outcome: ratio within the limits set by the Risk Management Meeting for each site.</p>	Key Performance Indicators
Reach new customers and expand services to existing customers using the HSBC brand and global network			Strategic objectives
Brand perception	Customer recommendation		

PFS	Business Banking	PFS	Business Banking	Key Performance Indicators
<p>Measure: an independent survey of brands around the world which judges their relative strength. The results are used to form a brand perception index, where the industry average is zero.</p>		<p>Measure: an independent survey of customers in up to 15 countries which judges how likely they are to recommend a particular brand. The results are used to create a customer recommendation index, where the industry average is zero.</p>		
<p>Target: to meet or exceed targets based on performance against key competitors and the industry average.</p>		<p>Target: to meet or exceed targets based on performance against key competitors and the industry average.</p>		
<p>Outcome: PFS and Business Banking customers judged HSBC's brand to be six points stronger than the competitor average. Our ratings met or exceeded our targets in 2010.</p>		<p>Outcome: Business Banking exceeded its target. Personal Financial Services fell short of its challenging target, but remained well above the competitor average.</p>		
<p><i>For footnotes, see page 83.</i></p>				

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<i>The management commentary included in the Report of the Directors: Overview and Operating and Financial Review, together with the Employees and Corporate sustainability sections of Governance and the Directors Remuneration Report is presented in compliance with the IFRS Practice Statement Management Commentary issued by the IASB.</i>	
Reconciliation of reported and underlying profit before tax	

We measure our performance internally on a like-for-like basis by eliminating the effects of foreign currency translation differences, acquisitions and disposals of subsidiaries and businesses, and fair value movements on own debt attributable to credit spread where the net result of such movements will be zero upon maturity of the debt; all of

which distort year-on-year comparisons. We refer to this as our underlying performance.

Reported results include the effects of the above items. They are excluded when monitoring progress against operating plans and past results because management believes that the underlying basis more accurately reflects operating performance.

Constant currency

Constant currency comparatives for 2009 referred to in the commentaries are computed by retranslating into US dollars for non-US dollar branches, subsidiaries, joint ventures and associates:

the income statements for 2009 at the average rates of exchange for 2010; and

the balance sheet at 31 December 2009 at the prevailing rates of exchange on 31 December 2010.

Constant currency comparatives for 2008 referred to in the 2009 commentaries are computed on the same basis, by applying average rates of exchange for 2009 to the 2008 income statement and rates of exchange on 31 December 2009 to the balance sheet at 31 December 2008.

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.

Underlying performance

The tables below compare our underlying performance in 2010 and 2009 with reported profits in those years.

The foreign currency translation differences reflect the relative strengthening of the US dollar against the euro and sterling, which offset its relative weakness against currencies in Asia, Mexico and Brazil during 2010.

The following acquisitions and disposals affected both comparisons:

the acquisition of PT Bank Ekonomi Raharja Tbk (Bank Ekonomi) in May 2009;

the gain on sale of our 49% interest in a joint venture for a UK merchant acquiring business in June 2009 of US\$280m;

the gain of US\$62m on reclassification of Bao Viet Holdings (Bao Viet) from an available-for-sale asset to an associate in January 2010;

the gain on sale of our stake in Wells Fargo HSBC Trade Bank in March 2010 of US\$66m;

the gain on disposal of HSBC Insurance Brokers Limited of US\$107m in April 2010;

the dilution gain of US\$188m which arose on our holding in Ping An Insurance (Group) Company of China, Limited (Ping An Insurance) following the issue of shares by the company in May 2010;

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the loss of US\$42m on the completion of the sale of our investment in British Arab Commercial Bank plc in October 2010;

the gain on sale of Eversholt Rail Group of US\$255m in December 2010; and
the gain of US\$74m on the deconsolidation of private equity funds following the management buy-out of Headland Capital Partners Ltd (formally known as HSBC Private Equity (Asia) Ltd) in November 2010.

Reconciliation of reported and underlying profit before tax

HSBC	2010 compared with 2009								
	2009 as reported US\$m	2009 adjust- ments ¹¹ US\$m	Currency translation ¹¹ US\$m	2009 at 2010 exchange rates ¹² US\$m	2010 as reported US\$m	2010 adjust- ments ¹⁰ US\$m	2010 under- lying US\$m	Re- ported change ¹³ %	Under- lying change ¹³ %
Net interest income	40,730	(1)	642	41,371	39,441	(31)	39,410	(3)	(5)
Net fee income	17,664	(210)	182	17,636	17,355	(3)	17,352	(2)	(2)
Changes in fair value ¹⁴	(6,533)	6,533			(63)	63		99	
Other income	14,320	(283)	228	14,265	11,514	(719)	10,795	(20)	(24)
Net operating income¹⁵	66,181	6,039	1,052	73,272	68,247	(690)	67,557	3	(8)
Loan impairment charges and other credit risk provisions	(26,488)		(330)	(26,818)	(14,039)		(14,039)	47	48
Net operating income	39,693	6,039	722	46,454	54,208	(690)	53,518	37	15
Operating expenses	(34,395)	200	(568)	(34,763)	(37,688)	19	(37,669)	(10)	(8)
Operating profit	5,298	6,239	154	11,691	16,520	(671)	15,849	212	36

Income from associates	1,781	(1)	11	1,791	2,517		2,517	41	41
Profit before tax	7,079	6,238	165	13,482	19,037	(671)	18,366	169	36
By geographical region									
Europe	4,009	2,546	(152)	6,403	4,302	(164)	4,138	7	(35)
Hong Kong	5,029	1	(10)	5,020	5,692	(130)	5,562	13	11
Rest of									
Asia-Pacific	4,200	3	205	4,408	5,902	(211)	5,691	41	29
Middle East	455		(2)	453	892	42	934	96	106
North America	(7,738)	3,688	46	(4,004)	454	(208)	246		
Latin America	1,124		78	1,202	1,795		1,795	60	49
Profit before tax	7,079	6,238	165	13,482	19,037	(671)	18,366	169	36
By customer group and global business									
Personal Financial Services	(2,065)	(2)	(70)	(2,137)	3,518	(10)	3,508		
Commercial Banking	4,275	(306)	64	4,033	6,090	(133)	5,957	42	48
Global Banking and Markets	10,481	13	173	10,667	9,536	(342)	9,194	(9)	(14)
Global Private Banking	1,108		1	1,109	1,054	1	1,055	(5)	(5)
Other	(6,720)	6,533	(3)	(190)	(1,161)	(187)	(1,348)	83	(609)
Profit before tax	7,079	6,238	165	13,482	19,037	(671)	18,366	169	36

For footnotes, see page 83.

Additional information is available on pages 47(a) to 47(f) and 80(b) to 80(g).

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)**Consolidated income statement***Five-year summary consolidated income statement*

	2010	2009	2008	2007	2006
	US\$m	US\$m	US\$m	US\$m	US\$m
Net interest income	39,441	40,730	42,563	37,795	34,486
Net fee income	17,355	17,664	20,024	22,002	17,182
Net trading income	7,210	9,863	6,560	9,834	8,222
Net income/(expense) from financial instruments					
designated at fair value	1,220	(3,531)	3,852	4,083	657
Gains less losses from financial investments	968	520	197	1,956	969
Gains arising from dilution of interests in associates	188			1,092	
Dividend income	112	126	272	324	340
Net earned insurance premiums	11,146	10,471	10,850	9,076	5,668
Gains on disposal of French regional banks			2,445		
Other operating income	2,374	2,788	1,808	1,439	2,546
Total operating income	80,014	78,631	88,571	87,601	70,070
Net insurance claims incurred and movement in liabilities to policyholders	(11,767)	(12,450)	(6,889)	(8,608)	(4,704)
Net operating income before loan impairment charges and other credit risk provisions	68,247	66,181	81,682	78,993	65,366
Loan impairment charges and other credit risk provisions	(14,039)	(26,488)	(24,937)	(17,242)	(10,573)
Net operating income	54,208	39,693	56,745	61,751	54,793
Total operating expenses ¹⁷	(37,688)	(34,395)	(49,099)	(39,042)	(33,553)
Operating profit	16,520	5,298	7,646	22,709	21,240

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Share of profit in associates and joint ventures	2,517	1,781	1,661	1,503	846
Profit before tax	19,037	7,079	9,307	24,212	22,086
Tax expense	(4,846)	(385)	(2,809)	(3,757)	(5,215)
Profit for the year	14,191	6,694	6,498	20,455	16,871
Profit attributable to shareholders of the parent company	13,159	5,834	5,728	19,133	15,789
Profit attributable to non-controlling interests	1,032	860	770	1,322	1,082
<i>Five-year financial information</i>					
	US\$	US\$	US\$	US\$	US\$
Basic earnings per share ¹⁸	0.73	0.34	0.41	1.44	1.22
Diluted earnings per share ¹⁸	0.72	0.34	0.41	1.42	1.21
Dividends per share ¹	0.34	0.34	0.93	0.87	0.76
	%	%	%	%	%
Dividend payout ratio ¹⁹	46.6	100.0	226.8	60.4	62.3
Post-tax return on average total assets	0.57	0.27	0.26	0.97	1.00
Return on average total shareholders' equity	9.5	5.1	4.7	15.9	15.7
Average foreign exchange translation rates to US\$:					
US\$1: £	0.648	0.641	0.545	0.500	0.543
US\$1:	0.755	0.719	0.684	0.731	0.797

For footnotes, see page 83.

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)

Reported profit before tax of US\$19.0bn in 2010 was 169% higher than in 2009, and 36% higher on an underlying basis. The difference between reported and underlying results is explained on page 14. Except where stated otherwise, the commentaries in the Financial Summary are on an underlying basis and references to HSBC Finance and HSBC Bank USA are on a management basis, rather than a legal entity basis (for details see page 37).

Net operating income before loan impairment charges and other credit risk provisions (revenue) was lower than in 2009, notably due to a decline in balances in North America, lower trading income from adverse movements on non-qualifying hedges and a fall in revenue from GB&M. In the former, we continued to reposition our core businesses and we remained focused on managing down our run-off portfolios. As a consequence, revenue fell, reflecting declining balances in the run-off portfolios and in the Card and Retail Services business, where revenue was also adversely affected by new regulations. In GB&M, lower revenue was generated in Balance Sheet Management as higher yielding positions matured and funds were invested in lower yielding assets. Trading income declined driven by increased competition and reduced margins across core products, and less favourable market conditions caused by the European sovereign debt crisis. These factors were partly offset by increased CMB revenue from balance sheet growth, particularly in Asia, and higher trade-related fees.

Loan impairment charges were significantly lower than in 2009, with decreases across all regions and customer groups as economic conditions improved. The most significant decline in loan impairment charges was in North America, reflecting lower balances due to increased repayments, an improvement in delinquency rates in Card and Retail Services, and the continued run-off of balances in the Consumer Finance business. There were also marked declines in the Middle East and in Latin America, primarily in Mexico and Brazil, reflecting a reduction in personal lending balances as selected portfolios were managed down, and an improvement in credit quality as origination criteria were tightened and collection practices improved. In GB&M, loan impairment charges were significantly lower, reflecting the improvement in the credit environment which resulted in fewer significant charges than those taken in 2009 in relation to a small number of clients, notably in Europe and other credit risk provisions fell in the available-for-sale asset-backed securities (ABS) portfolio due to a slowing in the rate of anticipated losses in the underlying collateral pools.

Underlying profit before tax rose by 36% as a significant fall in impairment charges offset a decline in revenue.

Operating expenses were higher than in 2009, in part due to specific one-off items such as a US\$0.3bn charge for UK bank payroll tax in 2010 and the non-recurrence of a pension accounting gain of US\$0.5bn in 2009 relating to the treatment of staff benefits. Excluding these items, operating expenses rose in support of strategic growth initiatives in our target markets to invest in operational infrastructure and the selective recruitment of customer-facing staff.

Income from associates increased, driven by strong results in Asia which reflected robust economic growth in mainland China.

In 2010, taxable profits were achieved in the US, principally as the result of a gain from an internal reorganisation that was not recognised for accounting purposes which increased the effective tax rate by 6.4 percentage points. If this were excluded, the effective tax rate would be 19.1% which is in line with our geographical range of business activities. Reported profit after tax was US\$7.5bn higher than in 2009.

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Report of the Directors: Operating and Financial Review (continued)**Group performance by income and expense item****Net interest income**

	2010 US\$m	2009 US\$m	2008 US\$m
Interest income	58,345	62,096	91,301
Interest expense	(18,904)	(21,366)	(48,738)
Net interest income ²⁰	39,441	40,730	42,563
Average interest-earning assets	1,472,294	1,384,705	1,466,622
Gross interest yield ²¹	3.96%	4.48%	6.23%
Net interest spread ²²	2.55%	2.90%	2.87%
Net interest margin ²³	2.68%	2.94%	2.90%

Summary of interest income by type of asset

	2010			2009			2008		
	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 %
Short-term funds and loans and advances to banks	236,742	4,555	1.92	192,578	4,199	2.18	240,111	9,646	4.02
Loans and advances to customers	858,499	44,186	5.15	870,057	48,301	5.55	943,662	68,722	7.28
Financial investments	378,971	9,375	2.47	322,880	9,425	2.92	264,396	12,618	4.77
Other interest-earning assets ²⁴	(1,918)	229	(11.94)	(810)	171	(21.11)	18,453	315	1.71
Total interest-earning assets	1,472,294	58,345	3.96	1,384,705	62,096	4.48	1,466,622	91,301	6.23
Trading assets ²⁵	332,511	6,027	1.81	357,504	7,614	2.13	428,539	16,742	3.91
Financial assets designated at fair value ²⁶	52,692 (22,905)	1,033	1.96	62,143 (26,308)	1,032	1.66	37,303 (20,360)	1,108	2.97

Impairment provisions Non-interest-earning assets	664,308			667,942			596,885		
Total assets and interest income	2,498,900	65,405	2.62	2,445,986	70,742	2.89	2,508,989	109,151	4.35

Summary of interest expense by type of liability and equity

	2010			2009			2008		
	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 %
Deposits by banks ²⁷	111,443	1,136	1.02	117,847	1,659	1.41	135,747	4,959	3.65
Financial liabilities designated at fair value – own debt issued ²⁸	66,706	1,271	1.91	60,221	1,558	2.59	63,835	3,133	4.91
Customer accounts ²⁹	962,613	10,778	1.12	940,918	11,346	1.21	950,854	27,989	2.94
Debt securities in issue	189,898	4,931	2.60	225,657	5,901	2.62	286,827	11,982	4.18
Other interest-bearing liabilities	8,730	788	9.03	8,640	902	10.44	14,579	675	4.63
Total interest-bearing liabilities	1,339,390	18,904	1.41	1,353,283	21,366	1.58	1,451,842	48,738	3.36
Trading liabilities	258,348	3,497	1.35	205,670	3,987	1.94	277,940	11,029	3.97
Financial liabilities designated at fair value (excluding own debt issued)	17,456	283	1.62	15,688	293	1.87	21,266	345	1.62
Non-interest bearing current accounts	142,579			123,271			98,193		
Total equity and other non-interest bearing liabilities	741,127			748,074			659,747		
Total equity and liabilities	2,498,900	22,684	0.91	2,445,986	25,646	1.05	2,508,988	60,112	2.40

For footnotes, see page 83.

Reported net interest income fell by 3% to US\$39bn; the decline was 5% on an underlying basis. This was driven by the exceptionally low interest rate environment and by the effect of repositioning our customer assets towards secured lending as we reduced our higher risk and higher yielding portfolios.

Revenues in Balance Sheet Management decreased, as expected, from the strong levels of 2009 as higher yielding positions taken in prior years matured and opportunities for reinvestment at equivalent yields were limited by the

prevailing low interest rates and flatter yield curves.

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The fall in income from interest-earning assets was driven by declining yields on loans and advances to customers following the Group's decision to reposition the lending portfolio towards higher quality assets. Higher yielding unsecured lending balances decreased, particularly in North America, where the run-off portfolios continued to diminish and credit card balances fell as the number of active accounts declined and repayments by customers increased. Certain higher risk portfolios were also managed down in Latin America, Asia and the Middle East. This reduction was partly offset by commercial lending growth in CMB and GB&M, and growth in secured lending in the UK in residential mortgages.

The interest expense on debt issued by the Group fell, largely due to a decline in average balances in debt securities in issue as HSBC Finance's funding requirements continued to decrease in line with the run-off of the residual balances in Mortgage Services and Consumer Lending and the sale of the vehicle finance portfolios.

Net interest income includes the expense of the internal funding of trading assets, while related revenue is reported in trading income. The cost of funding these assets declined as a result of the low interest rates. In reporting our customer group results, this cost is included within net trading income.

Net interest spread decreased due to lower yields on loans and advances to customers, partly as a result of the greater focus on secured lending. In addition, returns on financial investments and deposit spreads remained constrained due to low interest rates. Our net interest margin fell by a lesser amount due to the benefit from an increase in net free funds as customers held more funds in liquid non-interest bearing current accounts in the current low interest rate environment.

Net fee income

	2010	2009	2008
	US\$m	US\$m	US\$m
Cards	3,801	4,625	5,844
Account services	3,632	3,592	4,353
Funds under management	2,511	2,172	2,757
Broking income	1,789	1,617	1,738
Credit facilities	1,635	1,479	1,313
Insurance	1,147	1,421	1,771
Imports/exports	991	897	1,014
Global custody	700	988	1,311
Remittances	680	613	610
Underwriting	623	746	325
Unit trusts	560	363	502
Corporate finance	440	396	381
Trust income	291	278	325
Mortgage servicing	118	124	120
Maintenance income on operating leases	99	111	130
Taxpayer financial services	73	87	168
Other	2,027	1,894	2,102

Fee income	21,117	21,403	24,764
Less: fee expense	(3,762)	(3,739)	(4,740)
Net fee income	17,355	17,664	20,024

Net fee income marginally decreased compared with 2009 on both a reported and an underlying basis. The significant decrease in fee income in North America, primarily in Card and Retail Services, was mostly offset by higher investment-related fees in Asia and Europe and an increase in trade-related fee income in Asia.

The significant fall in fee income from cards occurred primarily in North America, driven by lower volumes, improved delinquency rates and the revision to charging practices following the implementation of the Credit Card Accountability, Responsibility and Disclosure Act (CARD Act).

Insurance fee income was markedly down. In the US, the decline resulted from lower sales of credit protection products associated with the cards business. In the UK, income was lower on a reported basis due to the sale of the insurance brokerage business in the first half of 2010.

Overall, underwriting fee income declined, particularly in Europe as a result of reduced capital market activity in the uncertain economic environment, although in Asia underwriting fees increased following several notable transactions.

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Net fee income from sales of investment products in Asia and Europe increased, driven by a stronger investment performance in funds and improved customer sentiment which led to higher volumes.

Credit facilities fees also rose, notably in Asia, as a result of an increase in loan syndication transactions completed during the year.

Net fee income from trade finance also increased, particularly in Asia, reflecting a rise in trade activity.

Net trading income

	2010 US\$m	2009 US\$m	2008 US\$m
Trading activities	5,708	5,312	2,988
Net interest income on trading activities	2,530	3,627	5,713
Other trading income hedge ineffectiveness:			
on cash flow hedges	(9)	90	(40)
on fair value hedges	38	(45)	5
Non-qualifying hedges	(1,057)	951	(1,122)
Losses on Bernard L. Madoff Investment Securities LLC fraud		(72)	(984)
Net trading income ^{30,31}	7,210	9,863	6,560

For footnotes, see page 83.

Reported net trading income was US\$7.2bn, 27% lower than in 2009. On an underlying basis, net trading income declined by 28% due to adverse movements on non-qualifying hedges and lower income from trading activities.

A US\$1.1bn adverse fair value movement was reported on non-qualifying hedges compared with a favourable fair value movement of US\$954m in 2009. These instruments are derivatives entered into as part of a documented interest rate management strategy for which hedge accounting was not, or could not be, applied. They are principally cross-currency and interest rate swaps used to economically hedge fixed rate debt issued by HSBC Holdings, floating rate debt issued by HSBC Finance and certain operating leased assets. The loss recognised on non-qualifying hedges was a result of fair value losses on these instruments, driven by the decrease in long-term US interest rates relative to sterling and euro rates. In HSBC Finance, the volume of non-qualifying hedge positions also increased as the duration of the mortgage book lengthened and swaps were used to align more closely the duration of the funding liabilities. The size and direction of the changes in fair value of non-qualifying hedges which are recognised in the income statement can be volatile from year to year, but do not alter the cash flows expected as part of the documented interest rate management strategy for both the instruments and the underlying economically hedged assets and liabilities.

The remaining decline in net trading income was driven by increased competition and reduced margins across core products. European sovereign debt concerns and increased economic uncertainty resulted in less favourable market conditions compared with 2009.

In the Credit business, corporate bond trading volumes remained robust following investment in electronic trading capabilities, though revenues were affected as margins declined and credit spread movements were more favourable in

2009. This was partly offset by gains on the legacy portfolio which included a net release of write-downs on legacy positions and monoline credit exposures of US\$429m. This compared with a reported write-down of US\$331m in 2009.

Rates income decreased, reflecting reduced margins and increased risk aversion from customers due to economic uncertainty. Turmoil in the eurozone led to sovereign debt downgrades and falling asset prices in certain European countries, leading to lower revenues in the trading portfolio. These factors were partly offset by a small favourable fair value movement on structured liabilities, compared with an adverse movement in 2009.

Lower net trading income was driven by a US\$2.0bn adverse movement on non-qualifying hedges from 2009.

Performance in the Foreign Exchange business remained strong, although was affected by a competitive trading environment and tighter bid-offer spreads as competitors sought to rebuild their businesses. In addition, revenues fell as market volatility declined from the exceptional levels seen in early 2009.

The Equities business continued to increase market share in its target markets, following

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investment in the equities platform. However, core revenues fell, as overall market volumes and margins declined.

Trading income benefited from foreign exchange gains on trading assets held as economic hedges of foreign currency debt designated at fair value compared with losses on these instruments in 2009. These gains were largely offset by

corresponding losses reported in Net income from financial instruments designated at fair value .

Net interest income earned on trading activities decreased by 30%, driven by reduced holdings of debt securities. The cost of internally funding these assets also declined, but this interest expense is reported under Net interest income and excluded from net trading income.

Net income/(expense) from financial instruments designated at fair value

	2010 US\$m	2009 US\$m	2008 US\$m
Net income/(expense) arising from:			
financial assets held to meet liabilities under insurance and investment contracts	2,349	3,793	(5,064)
liabilities to customers under investment contracts	(946)	(1,329)	1,751
HSBC's long-term debt issued and related derivatives	(258)	(6,247)	6,679
Change in own credit spread on long-term debt	(63)	(6,533)	6,570
Other changes in fair value ³²	(195)	286	109
other instruments designated at fair value and related derivatives	75	252	486
Net income/(expense) from financial instruments designated at fair value	1,220	(3,531)	3,852

Assets and liabilities from which net income/(expense) from financial instruments designated at fair value arose

	2010 US\$m	2009 US\$m	2008 US\$m
Financial assets designated at fair value at 31 December	37,011	37,181	28,533
Financial liabilities designated at fair value at 31 December	88,133	80,092	74,587
Including:			
Financial assets held to meet liabilities under:			
insurance contracts and investment contracts with DP ³	7,167	6,097	5,556
unit-linked insurance and other insurance and investment contracts	19,725	16,982	12,758

Long-term debt issues designated at fair value	69,906	62,641	58,686
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For footnotes, see page 83.

The accounting policies for the designation of financial instruments at fair value and the treatment of the associated income and expenses are described in Notes 2i and 2b on the Financial Statements, respectively.

The majority of the financial liabilities designated at fair value relate to certain fixed-rate long-term debt issues whose rate profile has been changed to floating through interest rate swaps as part of a documented interest rate management strategy. The movement in fair value of these long-term debt issues includes the effect of our credit spread changes and any ineffectiveness in the economic relationship between the related swaps and own debt. As credit spreads widen or narrow, accounting profits or losses, respectively, are booked. The size and direction of the changes in the credit spread on our debt and ineffectiveness, which are recognised in the income statement, can be volatile from year to year, but do not alter the cash flows envisaged as part of the documented interest rate management strategy. As a consequence, fair value movements arising from changes in our own credit spread on long-term debt and other fair value movements on the debt and related derivatives are not regarded internally as part of managed performance and are therefore not allocated to customer groups, but are reported in Other . Credit spread movements on own debt are excluded from underlying results, and related fair value movements are not included in the calculation of regulatory capital.

We reported net income from financial instruments designated at fair value of US\$1.2bn in 2010 compared with a net expense of US\$3.5bn in 2009. On an underlying basis, the equivalent figures were income of US\$1.3bn in 2010 and US\$2.9bn in 2009. The difference between the reported and underlying results arises from the exclusion from the latter of the credit spread-related movements in the fair value of our own long-term debt, on which we reported adverse fair value movements of US\$63m

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in 2010 and US\$6.5bn in 2009. In North America, a small favourable fair value movement was reported in 2010 as credit spreads widened marginally, in contrast with a significant adverse fair value movement in 2009. In Europe, significantly lower adverse fair value movements were reported in 2010 as credit spreads tightened, but to a lesser extent than in the previous year.

Income arising from financial assets held to meet liabilities under insurance and investment contracts reflected lower investment gains as the growth in equity markets was less than that of 2009. This predominantly affected the value of assets held to support unit-linked contracts in the UK, Hong Kong, Singapore and Brazil and participating contracts in France.

For investment gains or losses related to assets held to back investment contracts, the corresponding movement in liabilities to customers is also recorded under Net income from financial instruments designated at fair value .

Investment gains or losses related to assets held to back insurance contracts or investment contracts with discretionary participation features (DPF) are offset by a corresponding change in Net insurance claims incurred and movement in liabilities to policyholders to reflect the extent to which unit-linked policyholders, in particular, participate in the investment performance of the associated asset portfolios.

Gains less losses from financial investments

	2010 US\$m	2009 US\$m	2008 US\$m
Net gains/(losses) from disposal of:			
debt securities	564	463	19
equity securities	516	407	1,216
other financial investments	(7)	8	4
	1,073	878	1,239
Impairment of available-for-sale equity securities	(105)	(358)	(1,042)
Gains less losses from financial investments	968	520	197

Reported gains less losses from financial investments increased by US\$448m to US\$968m. On an underlying basis, excluding an accounting gain arising from the reclassification of Bao Viet as an associate following our purchase of additional shares, they increased by 69%. This was driven by a decrease in the level of impairments on available-for-sale equity investments as market values improved, along with an increase in gains on the disposal of equity and debt securities.

Impairments on equity investments declined markedly compared with 2009 as the improving economic situation resulted in a reduction in the level of write-downs required on private equity and other strategic equity investments.

Higher net gains were reported in Balance Sheet Management on disposals of available-for-sale debt securities, mainly in Europe and Asia. These were partly offset by a decrease in North America, where net gains realised from the sale of mortgage-backed securities and other ABSs in 2009 did not recur.

Net gains on the disposal of equity securities increased, primarily in our private equity portfolio in Europe, as the market offered greater opportunities for divestment. This was partly offset by the non-recurrence of the gain on disposal of our holdings of Visa Inc. shares in 2009.

Net earned insurance premiums

	2010	2009	2008
	US\$m	US\$m	US\$m
Gross insurance premium income	11,609	10,991	12,547
Reinsurance premiums	(463)	(520)	(1,697)
Net earned insurance premiums	11,146	10,471	10,850

Net earned insurance premiums increased by 6% to US\$11.1bn on both a reported and an underlying basis.

Growth was largely attributable to the continued strong performance of life insurance products in Asia. Successful sales campaigns and the

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recruitment of additional insurance sales managers increased net earned premiums in Hong Kong, particularly from deferred annuity and unit-linked products, and a life insurance product designed for high net worth individuals. Higher sales were also reported in Malaysia, Taiwan and mainland China, primarily from successful product launches and marketing campaigns.

Net earned premiums in Latin America increased marginally in the improved economic conditions, driven by higher sales in Brazil, Argentina and Mexico and repricing initiatives in Argentina.

In France, an increase in sales of investment contracts with DPF drove higher net earned premiums. Strong sales activity also led to higher net earned premiums in our UK life insurance business.

This growth was partly offset by a reduction in non-life insurance premiums, primarily due to the run-off of the legacy motor book in the UK, which was closed during the second half of 2009, and the decision taken during 2010 not to renew certain contracts in the Irish business.

Net earned premiums in North America also decreased, reflecting a decline in sales of payment protection products following the discontinuation of mortgage originations in HSBC Finance.

Other operating income

	2010 US\$m	2009 US\$m	2008 US\$m
Rent received	535	547	606
Losses recognised on assets held for sale	(263)	(115)	(130)
Valuation gains/(losses) on investment properties	93	(24)	(92)
Gain on disposal of property, plant and equipment, intangible assets and non-financial investments	889	1,033	881
Change in present value of in-force long-term insurance business	705	605	286
Other	603	742	257
Other operating income	2,562	2,788	1,808

Reported other operating income of US\$2.6bn was 8% lower than in 2009. Income in 2010 included gains of US\$188m following the dilution of our holding in Ping An Insurance, US\$107m from the sale of HSBC Insurance Brokers, US\$66m from the disposal of our interest in the Wells Fargo HSBC Trade Bank and US\$255m from the sale of Eversholt Rail Group. In addition, we reported a gain of US\$74m resulting from the sale of HSBC Private Equity (Asia) Ltd, partly offset by a loss of US\$42m on the disposal of our shareholding in British Arab Commercial Bank plc. Reported results in 2009 included a gain of US\$280m from the sale of the remaining stake in the card merchant-acquiring business in the UK.

On an underlying basis, excluding the items referred to above, other operating income decreased by 23%, primarily because gains on the sale of properties in London and Hong Kong in 2009 did not recur.

Net losses recognised on assets held for sale increased, reflecting a US\$207m loss on the sale of the US vehicle finance servicing operation and associated US\$5.3bn loan portfolio.

Net investment valuation gains on investment properties contrasted with losses in 2009. This reflected improvements in the property markets in Hong Kong and the UK which led to net valuation gains on investment properties, compared with net valuation losses in 2009.

A loss on sale of the US vehicle finance business contributed to a fall in Other operating income.

We recognised gains of US\$194m and US\$56m in 2010 on the sale and leaseback of our Paris and New York headquarters buildings, respectively. These compared with more substantial underlying gains of US\$667m (US\$686m as reported) on the sale and leaseback of 8 Canada Square and the sale of a property in Hong Kong in 2009.

Strong sales of life insurance products, notably in Hong Kong, resulted in favourable movements in the present value of in-force (PVIF) long-term insurance business. These were offset in part by the non-recurrence of gains recognised in 2009 following the refinement of the income recognition methodology in HSBC Finance.

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Report of the Directors: Operating and Financial Review (continued)**Net insurance claims incurred and movement in liabilities to policyholders**

	2010 US\$m	2009 US\$m	2008 US\$m
Insurance claims incurred and movement in liabilities to policyholders:			
gross	11,969	12,560	9,206
reinsurers share	(202)	(110)	(2,317)
net	11,767	12,450	6,889

For footnote, see page 83.

Net insurance claims incurred and movement in liabilities to policyholders decreased by 5% and 4% on a reported and an underlying basis, respectively.

Lower investment returns than in 2009, particularly in Asia, Europe and Brazil, led to a decrease in the movement in liabilities to policyholders on unit-linked insurance contracts and, to a certain extent, participating contracts, whose policyholders share in the investment performance of the assets supporting their policies. The gains or losses experienced on the financial assets designated at fair value held to support insurance contract liabilities and investment contracts with DPF are reported in Net income from financial instruments designated at fair value.

In Asia, the effect of the lower investment returns was more than offset by additional reserves established for new business written, consistent with the increase in net insurance premiums earned, particularly in Hong Kong, as a result of successful sales campaigns and the recruitment of additional insurance sales managers.

In addition, the increase in reserves in 2009 on the now closed UK motor insurance book, which reflected the rising incidence and severity of claims at that time, did not recur. The decision taken in 2010 not to renew certain contracts in our Irish business resulted in a further decrease in net insurance claims incurred and movement in liabilities to policyholders.

Loan impairment charges and other credit risk provisions

	2010 US\$m	2009 US\$m	2008 US\$m
Loan impairment charges			
New allowances net of allowance releases	14,568	25,832	24,965
Recoveries of amounts previously written off	(1,020)	(890)	(834)
	13,548	24,942	24,131
Individually assessed allowances	2,625	4,458	2,064
Collectively assessed allowances	10,923	20,484	22,067

Impairment of available-for-sale debt securities	472	1,474	737
Other credit risk provisions	19	72	69
Loan impairment charges and other credit risk provisions	14,039	26,488	24,937
	%	%	%
as a percentage of net operating income excluding the effect of fair value movements in respect of credit spread on own debt and before loan impairment charges and other credit risk provisions	20.6	36.4	33.2
Impairment charges on loans and advances to customers as a percentage of gross average loans and advances to customers	1.5	2.8	2.5
	US\$m	US\$m	US\$m
Customer impaired loans	28,091	30,606	25,352
Customer loan impairment allowances	20,083	25,542	23,909

On a reported basis, loan impairment charges and other credit risk provisions were US\$14bn, a decline of 47% compared with 2009 and 48% on an underlying basis. There was improvement across all regions and in all customer groups.

At 31 December 2010, the aggregate balance of customer loan impairment allowances was US\$20.1bn. This represented 2.2% of gross loans and advances to customers (net of reverse repos and settlement accounts) compared with 3.0% at 31 December 2009.

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We actively managed down some of our higher risk portfolios in all regions and enhanced credit quality through tighter underwriting and increased focus on the sale of secured products to customers where we already held a banking relationship. Loan impairment charges in our CMB and GB&M businesses fell as economic conditions improved and we recognised fewer large loan impairment charges against specific clients than in 2009.

Loan impairment charges and other credit risk provisions of US\$14bn were 48% or US\$12.8bn lower than in 2009.

Impairments on available-for-sale debt securities declined markedly to US\$472m from the US\$1.5bn reported in 2009, mainly reflecting a slowing in the rate of anticipated losses in the underlying collateral pools.

The most significant decline in loan impairment charges was in our HSBC Finance portfolios in **the US**, where lending balances reduced and delinquency levels improved.

Loan impairment charges and other credit risk provisions in the US declined by 48% to US\$7.9bn, the lowest level since 2006, representing 57% of the Group's total reduction compared with 2009. This mainly occurred in the US PFS business, where loan impairment charges declined by US\$6.1bn to US\$8.0bn, primarily in the Card and Retail Services business of HSBC Finance and, to a lesser extent, in the run-off consumer finance portfolios.

In Cards and Retail Services, loan impairment charges declined by 57% to US\$2.2bn. This improvement reflected the continuing effects of additional steps taken from the fourth quarter of 2007 to manage risk, including tightening underwriting criteria, lowering credit limits and reducing the number of active cards. An increased focus by our customers on reducing outstanding credit card debt helped improve delinquency levels.

Loan impairment charges in our Consumer Lending and Mortgage Services businesses declined by 29% to US\$5.7bn, due to the continued run-off of lending balances in these portfolios and lower delinquency balances. Total loss severities on foreclosed loans improved compared with 2009, reflecting an increase in the number of properties for which we accepted a deed in lieu of foreclosure or a short sale, both of which result in lower losses compared with loans which are subject to a formal foreclosure process.

During 2010, state and federal prosecutors announced investigations into foreclosure practices of certain mortgage service providers. As a result, we expect that the scrutiny of documents will increase, and in some states additional verification of information will be required. If these trends continue there may be delays in their processing. See page 83 for more information on the investigation into US foreclosure practices.

In HSBC Bank USA, loan impairment charges in PFS fell by 92% to US\$50m, reflecting lower lending balances and improved credit quality in the residential mortgage portfolio.

In GB&M in the US, a net release of loan impairment charges and other credit risk provisions reflected the improved credit environment and a release of impairments of available-for-sale ABSs as mentioned previously. In CMB, loan impairment charges declined by US\$194m as the improved economic conditions resulted in credit upgrades on certain accounts, and fewer downgrades across all business lines.

In **the UK**, loan impairment charges in PFS and CMB declined as economic conditions improved and interest rates remained at low levels, resulting in an improvement in delinquency levels. In PFS, loan impairment charges fell by 35% to US\$1.1bn as we actively reduced our exposure to unsecured lending, while collections increased mainly due to programmes implemented to improve performance. In the UK secured lending book, credit quality continued to be high and loan impairment charges remained at low levels. In CMB, loan impairment charges declined by US\$159m due to strengthened credit risk management and improved collections, notably in the UK property, retail and service sectors.

Loan impairment charges and other credit provisions fell markedly in GB&M reflecting the improved credit outlook, loan restructuring activity and the non-recurrence of significant charges against a small number of clients in the financial and property sectors. Credit risk provisions on certain available-for-sale ABSs also reduced.

Loan impairment charges and other credit risk provisions in **Latin America** declined by 44% to US\$1.5bn. In PFS, loan impairment charges of US\$1.2bn were 45% lower, mainly in Mexico due to a reduction in balances and improved delinquency rates in our credit card portfolio. In Brazil, they also declined as we managed down the size of certain consumer finance portfolios and economic conditions improved. In 2010, initiatives taken in the region to improve the quality of the loan portfolios continued. These steps included the tightening of underwriting criteria, reducing and, in some

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instances, eliminating the use of higher risk, non-branch sales channels, and continued investment in our collections infrastructure. In our CMB portfolios, loan impairment charges and other credit risk provisions declined by 50% to US\$293m, as improved economic conditions and credit quality resulted in lower specific impairment charges in all sectors.

In the **Middle East**, loan impairment charges and other credit risk provisions fell by 53% to US\$627m as lower loan impairment charges in both PFS and CMB were partly offset by an increase in GB&M following restructuring activities. In our PFS business, loan impairment charges declined by 61% to US\$227m, reflecting a marked decline in delinquency levels and lower lending balances, particularly in our credit card and unsecured personal lending book, as a result of managing down higher risk portfolios. Credit limits were tightened and our customer acquisition strategy was revised in the region to concentrate on Premier and Advance customers. This resulted in an improvement in credit quality. In CMB, lower loan impairment charges reflected a reduction in collective impairment charges and fewer specific loan impairment charges as economic conditions improved.

In **Rest of Asia-Pacific**, loan impairment charges declined as the credit environment improved. In India, loan impairment charges fell by 83% to US\$82m, mainly in PFS as certain unsecured lending portfolios and the higher risk elements of the credit card portfolio were managed down, and economic conditions improved. Impairment charges also declined in CMB, due to the non-recurrence of charges against specific technology-related exposures in 2009. Partly offsetting these increases were higher specific loan impairment charges in GB&M.

In **Hong Kong**, loan impairment charges fell by 77% to US\$114m, as economic conditions improved and fewer large specific loan impairment charges were reported against the CMB and GB&M portfolios. Loan impairment charges fell in PFS too, mainly on unsecured lending as unemployment and bankruptcy levels reduced.

Operating expenses

	2010 US\$m	2009 US\$m	2008 US\$m
By expense category			
Employee compensation and benefits	19,836	18,468	20,792
Premises and equipment (excluding depreciation and impairment)	4,348	4,099	4,305
General and administrative expenses	10,808	9,293	10,955
Administrative expenses	34,992	31,860	36,052
Depreciation and impairment of property, plant and equipment	1,713	1,725	1,750
Amortisation and impairment of intangible assets	983	810	733
Goodwill impairment			10,564
Operating expenses	37,688	34,395	49,099

Staff numbers (full time equivalents)

	At 31 December		
	2010	2009	2008
Europe	75,698	76,703	82,093
Hong Kong	29,171	27,614	29,330
Rest of Asia-Pacific	91,607	87,141	89,706
Middle East	8,676	8,281	8,453
North America	33,865	35,458	44,725
Latin America	56,044	54,288	58,559
Staff numbers	295,061	289,485	312,866

Operating expenses increased by 10% to US\$37.7bn on a reported basis and by 8% on an underlying basis. Significant one-off items included aggregate payroll taxes of US\$324m levied on 2009 bonuses in the UK and France, and the curtailment of certain benefits delivered through pension schemes, which generated accounting credits of US\$148m in the US and US\$480m (US\$499m as reported) in the UK in

2010 and 2009, respectively. Excluding these items, expenses grew by 6% as we continued to invest in our operational infrastructure, customer-facing and support staff, and GB&M's capabilities and platforms.

Employee compensation and benefits increased by 7%, partly due to the net effect of the curtailment gains and the payroll tax referred to above.

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Excluding these items, staff costs rose by 3%. Performance-related costs increased, primarily in Asia, reflecting improved business performance and increased staff numbers. While year-end staff numbers increased as the pace of recruitment accelerated in the second half of the year, average staff numbers remained below 2009 levels. The growth in staff numbers in Asia encompassed both customer-facing and back-office staff supporting business growth and increased operational capacity. In Latin America, staff costs grew following union-agreed salary increases and the recruitment of customer-facing and regional support staff, primarily in the latter part of the year. We also increased resources in our Global Service Centres as we continued to move processes there.

Staff costs declined in the US due to the non-recurrence of restructuring costs associated with the closure of the Consumer Lending branch network in 2009. Also, headcount fell due to the sale of the vehicle finance portfolio and related servicing platform. Similarly, reported staff numbers fell in Europe due to the sale of the insurance broking business in the UK and business reorganisation in France, though this was partly offset by higher numbers of customer-facing staff in the UK and Turkey.

Premises and equipment costs increased as rental costs in the UK, the US and France rose following the sale and leaseback of 8 Canada Square, London and our headquarters buildings in the US and France, combined with business expansion in Asia and Europe and refurbishment costs in Europe and Latin America. This was partly offset by lower costs in the US following the closure of the Consumer Lending branch offices and the non-recurrence of the related restructuring costs.

General and administrative expenses rose, reflecting in part higher marketing and advertising costs. These grew in North America in Card and Retail Services, partly from complying with the CARD Act. Marketing costs also rose in Asia and Latin America in support of the launch of Advance and sales campaigns for credit cards and investment products. Project costs increased from various initiatives to enhance operational capabilities, in connection with which consultancy and contractors' fees rose, primarily in the UK as GB&M continued to invest in strategic initiatives to drive future revenue growth. These included the development of Prime Services and equity market capabilities, and the expansion of the Rates and foreign exchange e-commerce platforms.

Travel costs increased as we increased our focus on international connectivity and business growth. Costs also increased due to litigation provisions in North America and Europe.

Cost efficiency ratios

	2010	2009	2008
	%	%	%
HSBC	55.2	52.0	60.1
Personal Financial Services	57.7	51.7	76.4
Europe	67.4	68.7	62.7
Hong Kong	35.3	34.9	32.2
Rest of Asia-Pacific	85.1	81.2	81.5
Middle East	62.2	53.5	53.2
North America	46.9	38.1	106.8
Latin America	72.1	66.7	59.7

Commercial Banking	49.4	46.4	43.0
Europe	51.9	47.4	44.2
Hong Kong	32.2	33.7	26.2
Rest of Asia-Pacific	49.2	47.0	45.9
Middle East	36.4	33.8	32.0
North America	46.6	47.7	46.1
Latin America	65.7	57.0	55.0
Global Banking and Markets	49.9	39.1	67.3
Global Private Banking	65.8	60.5	58.3

Our cost efficiency ratio worsened by 3.2 percentage points on a reported basis and by 8.4 percentage points to 55.8% on an underlying basis.

In PFS, there was a deterioration of 5.7 percentage points in the cost efficiency ratio. Operating expenses remained broadly unchanged as a rise in costs in

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Asia in support of business expansion was broadly offset by strict cost control across the Group and lower costs in the US. Revenue fell, largely in the run-off portfolio and in Card and Retail Services in North America.

In CMB, the cost efficiency ratio deteriorated by 2.9 percentage points as we continued to invest for future revenue growth in those markets that we see as central to international connectivity. Revenue grew in all regions, albeit at a slower pace, resulting in a deterioration in the cost efficiency ratio, with the exception of Hong Kong where strong revenue growth led to an improvement of 1.5 percentage points.

In GB&M, the cost efficiency ratio deteriorated by 12.1 percentage points reflecting the one-off payroll and bonus taxes in the UK and France. Excluding them, the ratio deteriorated by 10.5 percentage points following a rise in costs related to higher support costs and continued investment in strategic initiatives being undertaken to drive future revenue growth. Revenue fell during 2010 mainly due to lower net interest income in Balance Sheet Management and lower trading income.

In GPB, the cost efficiency ratio deteriorated by 5.3 percentage points as costs increased, reflecting the hiring of front-line staff, investment in systems and higher compliance costs coupled with lower revenue in the low interest rate environment.

Share of profit in associates and joint ventures

	2010	2009	2008
	US\$m	US\$m	US\$m
Associates			
Bank of Communications Co., Limited	987	754	741
Ping An Insurance (Group) Company of China, Limited	848	551	324
Industrial Bank Co., Limited	327	216	221
The Saudi British Bank	161	172	251
Other	156	42	63
Share of profit in associates	2,479	1,735	1,600
Share of profit in joint ventures	38	46	61
Share of profit in associates and joint ventures	2,517	1,781	1,661

The share of profit from associates and joint ventures increased by 41% to US\$2.5bn on both a reported and an underlying basis as our associates in mainland China capitalised on the improved economic conditions in region.

Our share of profits in Ping An Insurance increased due to strong insurance sales performance, while fee income and lending growth resulted in higher profits from the Bank of Communications Co., Limited (Bank of Communications) and from Industrial Bank Co., Limited (Industrial Bank).

These results were partly offset by a decrease in our share of profits from The Saudi British Bank as revenue declined amidst challenging economic conditions.

Tax expense

	2010	2009	2008
	US\$m	US\$m	US\$m
Profit before tax	19,037	7,079	9,307
Tax expense	(4,846)	(385)	(2,809)
Profit after tax	14,191	6,694	6,498
Effective tax rate	25.5%	5.4%	30.2%

The most significant factor influencing the year on year changes to the effective tax rate is the changing geographical split of profits, including the relative proportion of tax on the share of profits in associates and joint ventures included within profit before tax. The impact of the tax on profit on associates and joint ventures included within pre-tax profits was a reduction in the effective tax rate of 3.7% in 2010 and 7.1% in 2009.

In 2010 HSBC's US operations achieved taxable profits, principally as a result of realising a taxable gain from an internal reorganisation which increased the effective tax rate by 6.4%. If this was excluded the effective tax rate would be 19.1% which is in line with the geographic profile of the Group.

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HSBC	2009 compared with 2008								
	2008 as reported US\$m	2008 adjust- ments ¹ US\$m	Currency translation ¹¹ US\$m	2008 at 2009 exchange rates ¹⁶ US\$m	2009 as reported US\$m	2009 adjust- ments ¹⁰ US\$m	2009 under- lying US\$m	Re- ported change ¹³ %	Under- lying change ¹³ %
Net interest income	42,563	(65)	(2,062)	40,436	40,730	(53)	40,677	(4)	1
Net fee income	20,024	(58)	(1,315)	18,651	17,664	(6)	17,658	(12)	(5)
Changes in fair value ¹⁴	6,570	(6,570)			(6,533)	6,533			
Gains on disposal of French regional banks	2,445	(2,445)						(100)	
Other income	10,080	(680)	(1,597)	7,803	14,320	(298)	14,022	42	80
Net operating income ¹⁵	81,682	(9,818)	(4,974)	66,890	66,181	6,176	72,357	(19)	8
Loan impairment charges and other credit risk provisions	(24,937)	6	709	(24,222)	(26,488)		(26,488)	(6)	(9)
Net operating income	56,745	(9,812)	(4,265)	42,668	39,693	6,176	45,869	(30)	8
Operating expenses (excluding goodwill impairment)	(38,535)	68	2,655	(35,812)	(34,395)	31	(34,364)	11	4
Goodwill impairment	(10,564)			(10,564)				100	100

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Operating profit	7,646	(9,744)	(1,610)	(3,708)	5,298	6,207	11,505	(31)	
Income from associates	1,661		25	1,686	1,781		1,781	7	6
Profit before tax	9,307	(9,744)	(1,585)	(2,022)	7,079	6,207	13,286	(24)	
By geographical region									
Europe	10,869	(6,221)	(1,054)	3,594	4,009	2,561	6,570	(63)	83
Hong Kong	5,461	(5)	20	5,476	5,029	1	5,030	(8)	(8)
Rest of Asia-Pacific	4,722	(3)	(184)	4,535	4,200	(43)	4,157	(11)	(8)
Middle East	1,746		(7)	1,739	455		455	(74)	(74)
North America	(15,528)	(3,444)	(67)	(19,039)	(7,738)	3,688	(4,050)	50	79
Latin America	2,037	(71)	(293)	1,673	1,124		1,124	(45)	(33)
Profit before tax	9,307	(9,744)	(1,585)	(2,022)	7,079	6,207	13,286	(24)	
By customer group and global business									
Personal Financial Services	(10,974)	(148)	(457)	(11,579)	(2,065)	(3)	(2,068)	81	82
Commercial Banking	7,194	(486)	(665)	6,043	4,275	(318)	3,957	(41)	(35)
Global Banking and Markets	3,483		(479)	3,004	10,481	(5)	10,476	201	249
Global Private Banking	1,447		(48)	1,399	1,108		1,108	(23)	(21)
Other	8,157	(9,110)	64	(889)	(6,720)	6,533	(187)		79
Profit before tax	9,307	(9,744)	(1,585)	(2,022)	7,079	6,207	13,286	(24)	

Consolidated income statement

Our reported pre-tax profits in 2009 fell by 24% to US\$7.1bn and earnings per share declined to US\$0.34. Return on average shareholders' equity remained broadly at 2008 levels at 5.1% (2008: 4.7%).

On an underlying basis, our profit before tax increased by US\$15.3bn compared with 2008. The difference between reported and underlying results is explained on page 14. Except where otherwise stated, the commentaries in the Financial Summary are on an underlying basis.

Profit before tax on an underlying basis and excluding the goodwill impairment charge of US\$10.6bn in 2008, was 56% or US\$4.7bn higher.

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The increase in profit before tax was driven by strong growth in net operating income in GB&M, in part reflecting the absence of significant write-downs in securities and structured credit positions which had affected results in 2008. More significantly, the business benefited from market share gains in core activities and the effect of early positioning by Balance Sheet Management, in anticipation of the low interest rate environment. Results in 2009 also reflected lower loan impairment charges in North America, partly offset by an increase in loan impairment charges and other credit risk provisions elsewhere.

Although our business in North America continued to record a loss, performance improved as write-downs in GB&M reduced and loan impairment charges in PFS decreased. This resulted from steps taken to curtail origination in 2007 and 2008, which culminated in the closure of the Consumer Lending branch network in the second quarter of 2009, and from our decision to place all consumer finance portfolios other than credit cards into run-off. The closure of the branch network fed through to lower operating expenses during the remainder of the year.

In Hong Kong, economic performance remained robust despite continuing challenges, with our results underpinned by a market-leading share in deposits, residential mortgages, cards and insurance. Overall profitability declined, however, as revenue was driven lower by compressed deposit spreads in the low interest rate environment. Loan impairment charges improved on 2008, remaining low, and operating expenses reflected a disciplined approach to cost management.

In the Rest of Asia-Pacific region, the economic challenges faced were similar to those in Hong Kong and their impact was reflected in lower income and higher loan impairment charges. Income from associates, primarily in mainland China, made a significant positive contribution to the region's performance. We continued to expand our presence in Rest of Asia-Pacific through organic growth and strategic investment.

Our Middle East operations suffered from a combination of factors: a severe contraction in the economy of Dubai, a fall in oil revenues for much of the year and investment losses incurred by many regional investors. This led to a decline in profit before tax of 74%, primarily due to a significant increase in loan impairment charges. The regional economic downturn and continuing uncertainty affected both retail and corporate customers, particularly in the United Arab Emirates (UAE) where the downturn was most pronounced.

In Europe, we reported an increase in profit before tax on an underlying basis, driven by GB&M in London and Paris. This resulted from a strong performance in Rates and Balance Sheet Management, coupled with the benefit of stabilisation of asset prices and general tightening of credit spreads and lower write-downs in the credit trading business. This was partly offset by a reduction in deposit spreads in PFS and CMB as interest rates fell, and an increase in loan impairment charges in Global Banking, reflecting a deterioration in the credit position of a small number of clients.

The increase in profit before tax was driven by strong growth in GB&M.

In Latin America, the decline in pre-tax profits was driven by an increase in loan impairment charges in PFS and CMB and lower revenues in PFS, partly offset by a strong performance in trading and Balance Sheet Management in GB&M. The lower revenues in PFS were in part due to the continued curtailment of personal unsecured credit exposures, following our adverse experience in 2008, with net interest income also adversely affected by declining interest rates and narrowing spreads.

With the exception of PFS, which continued to be heavily affected by the consumer finance losses in North America, all customer groups remained profitable.

The following items are significant to a comparison of reported results with 2008:

the non-recurrence of the US\$10.6bn goodwill impairment charge in North America recorded in 2008;

the non-recurrence of a US\$2.4bn gain on the sale of French regional banks in 2008;

fair value losses relating to own credit spreads of US\$6.5bn in 2009 compared with gains of US\$6.6bn in 2008;

a US\$72m fraud loss relating to Bernard L Madoff Investment Securities LLC (Madoff Securities) in 2009, which was in addition to the US\$984m charge reported in 2008;

loss from write-downs in legacy securities and structured credit positions amounting to US\$0.3bn in 2009 compared with US\$5.4bn in 2008;

the acquisition in 2008 of the subsidiary, Project Maple II B.V., which owned our headquarters at 8 Canada Square, London E14 5HQ and the subsequent sale of the company and leaseback of

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the property in 2009, resulting in gains of US\$0.6bn in 2009 and US\$0.4bn in 2008;

the sale of the card merchant-acquiring business in the UK, resulting in gains of US\$0.3bn in 2009 and US\$0.4bn in 2008;

the change in the basis of delivering long-term employee benefits in the UK, which generated a one-off accounting gain of US\$0.5bn in 2009; and

the tax expense of US\$0.3bn in 2009, which was lower than in previous years as a result of the geographic distribution of income. We generated profits in low tax rate jurisdictions, principally Asia, and incurred losses in high tax rate jurisdictions, principally the US, which when mixed produced a low overall rate.

Group performance by income and expense item

Net interest income

Our reported net interest income of US\$40.7bn fell by 4% compared with 2008, but was marginally higher on an underlying basis.

Reported net interest income includes the expense of the internal funding of trading assets, while related revenue is reported in trading income. The cost of internally funding these assets declined significantly as a result of the low interest rate environment. In our customer group reporting, this cost is included within trading income.

Deposit spreads were squeezed by the exceptionally low interest rates, although this was partly offset by the reduced cost of funding trading activities. Strong revenues in Balance Sheet Management reflected positions taken in 2008 ahead of the reduction in major currency interest rates. As these positions began to mature, the revenue from Balance Sheet Management's activities reduced but remained strong in the second half of 2009.

Average interest-earning assets fell slightly due to a decline in term lending, mainly from the run-off portfolios in North America and the decline in consumer credit appetite globally.

Average interest-bearing liabilities also decreased, due to a decline in debt securities in issue as funding requirements for HSBC Finance fell as certain portfolios were managed down. This was largely offset by a rise in current account balances, driven by growth in customer demand for more liquid assets. The very low interest rates led to clients holding an increasing proportion of funds in liquid current accounts rather than in savings and deposit accounts as they positioned for rising interest rates or prospective investment opportunities.

Competition for deposits and exceptionally low interest rates squeezed deposit margins.

The net interest spread rose slightly. As a result of continuing deposit inflows, we sourced an increasing proportion of our funding from customer accounts, and consequently reduced our reliance on relatively more expensive debt securities. The benefit of this was largely offset, however, by a decline in customer lending, particularly higher yielding personal lending, which reduced the average yield on assets.

Net fee income

Reported net fee income decreased by 12% to US\$17.7bn, 5% lower on an underlying basis.

Lower credit card fees and weaker equity markets led to a decline in net fee income.

Credit card fees fell significantly, mainly in North America, reflecting lower transaction volumes, a reduction in cards in issue and changes in customer behaviour which led to lower cash advance, interchange, late and overlimit

fees. In the UK, the decrease primarily arose from the disposal of the card-acquiring business to a joint venture in June 2008.

Weaker equity markets and subdued investor sentiment for higher risk products led to a reduction in both the volume and the value of equity-related products. This resulted in a decrease in fees generated from funds under management, global custody and unit trusts, though fees grew from equity capital markets products in GB&M. The impact was particularly marked in the first half of 2009, though market-related fees recovered somewhat in the second half of the year as market values rose and investor appetite for equity products increased.

Account services fees fell, predominantly in North America as the result of a decline in credit card volumes and changes in customer behaviour, and in GBP due to a decrease in fiduciary deposit commissions as lower interest rates drove down balances.

Insurance broking fees also fell, mainly due to lower origination volumes of credit-related products, principally in the US consumer finance business, and reduced payment protection business in the UK.

Corporate credit facility and underwriting fees increased strongly on the back of higher debt originations in Europe and North America which

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accompanied the considerable reconstruction and refinancing of corporate balance sheets in 2009.

Net trading income

Reported net trading income increased by 50% to US\$9.9bn, 83% higher on an underlying basis.

Reported trading income excludes the interest expense of the internal funding of trading assets. As noted in Net interest income, the cost of internally funding these assets declined significantly as a result of the low interest rate environment.

The Credit business benefited from a general tightening of credit spreads following a return of liquidity to much of the market, and the write-downs on legacy positions in Credit trading declined significantly following the stabilisation of asset prices.

Net trading income rose by 83% on an underlying basis.

An increase in Rates revenues, particularly in the first half of the year, reflected increased market share and client trading volumes, wider bid-offer spreads and early positioning for interest rate movements. Partly offsetting these gains, fair value losses were recorded on our structured liabilities as a result of credit spreads tightening, compared with gains in this area in 2008.

Equities benefited from the non-recurrence of the US\$984m charge reported in 2008 in respect of Madoff Securities. The core Equities business also took advantage of a changed competitive landscape to capture a greater share of business in strategic markets from key institutional clients.

Foreign exchange trading revenues were well ahead of 2007, but fell short of the record year in 2008. This reflected a combination of reduced customer volumes from lower trade flows and investment activity, and relatively lower market volatility.

Tightening credit spreads led to losses of US\$429m on credit default swap transactions in parts of the Global Banking portfolio. In 2008, gains of US\$912m were reported on these credit default swaps as a result of widening credit spreads.

A reduction in net interest income on trading activities reflected the sharp fall in interest rates at the end of 2008 but was partly compensated for by a reduction in the internal funding cost of trading activities, which is reported in Net interest income.

Income from non-qualifying hedges related to mark-to-market gains on cross-currency swaps as the US dollar depreciated against sterling, and on interest rate swaps as US dollar long and medium term interest rates increased over the year. In 2008, appreciation of the US dollar and a fall in interest rates led to mark-to-market losses on these instruments.

During the second half of 2008, we reclassified US\$17.9bn of assets from held for trading to loans and receivables and available for sale following the IASB's amendment to International Accounting Standard (IAS) 39. Had these reclassifications not taken place and the assets had continued to be accounted for on a fair value basis, we would have recorded additional gains of US\$1.5bn in 2009 (2008: losses of US\$3.5bn).

Net income from financial instruments designated at fair value

We designate certain financial instruments at fair value 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 from financial instruments designated at fair value are included in this line except for interest arising from our issued debt securities and related derivatives managed in conjunction with those debt securities, which is recognised in Interest expense.

We principally use the fair value designation in the following instances (for which all numbers are reported):

for certain fixed-rate long-term debt issues whose rate profile has been changed to floating through interest rate swaps as part of a documented interest rate management strategy. Approximately US\$63bn (2008: US\$59bn) of our 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 widen or narrow, accounting profits or losses, respectively, are booked. The size and direction of the accounting consequences of changes in own credit spread and ineffectiveness can be volatile from year to year, but do not alter the cash flows envisaged as part of the documented interest rate management strategy. As a consequence, gains and losses arising from changes in own credit spread on long-term debt are not regarded internally as part of managed performance and are excluded from underlying results. Similarly, such gains and

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losses are ignored in the calculation of regulatory capital;

for US\$15bn (2008: US\$11bn) of financial assets held to meet liabilities under insurance contracts, and certain liabilities under investment contracts with discretionary participation features; and

for US\$8bn (2008: US\$7bn) of financial assets held to meet liabilities under unit-linked and other investment contracts, as well as the associated liabilities.

A net expense from financial instruments designated at fair value of US\$3.5bn was reported compared with income of US\$3.9bn in 2008.

A significant change in credit spread on our own debt in 2009 reversed the movement in 2008.

On an underlying basis, we reported income of US\$3.0bn in 2009 compared with an expense of US\$2.6bn in 2008. The large difference between the reported and underlying results is due to the exclusion of the effect of credit spread-related movements in the fair value of our own long-term debt from underlying performance.

Income of US\$3.8bn was recorded due to a fair value movement on assets held to back insurance and investment contracts, compared with an expense of US\$4.8bn in 2008. This reflected investment gains in the current year driven by improved market performance, predominantly affecting the value of assets held in unit-linked and participating funds in Hong Kong, the UK and France.

To the extent that the investment gains related to assets held to back investment contracts, the expense associated with the corresponding increase in liabilities to customers was also recorded under net income from financial instruments designated at fair value. This expense amounted to US\$1.3bn in 2009 compared with an income of US\$1.5bn in 2008 when liabilities fell in line with declining asset markets.

To the extent that the investment gains related to assets held to back insurance contracts, they were offset by a corresponding increase in Net insurance claims and movement in liabilities to policyholders to reflect the extent to which unit-linked policyholders, in particular, participate in the investment performance experienced in the associated asset portfolios.

Gains less losses from financial investments

Reported gains less losses from financial investments increased by US\$323m to US\$520m. On an underlying basis, they increased by US\$546m.

Net gains on the disposal of debt securities increased significantly, due to gains recorded on the sale of mortgage-backed securities in North America. They were supplemented by smaller gains, principally on the disposal of available-for-sale bonds in Latin America and the UK.

Sales of Visa shares contributed significant gains during 2008, with additional gains from further sales in 2009. Other gains recognised during 2008, including those recorded on the sale of MasterCard shares, were not repeated in 2009.

A significantly lower level of impairments on equity investments was recognised in 2009 than in 2008 in Asia, Europe and North America, reflecting the improvement in the economic situation and equity markets. Of the investments on which material impairments were recognised in 2008, a significant amount reversed during 2009 due to share price appreciation, notably in India and, to a lesser extent, Vietnam; however, under IFRSs all subsequent increases in the fair value are treated as a revaluation and are recognised in other comprehensive income rather than the income statement.

Net earned insurance premiums

Reported net earned insurance premiums amounted to US\$10.5bn, a decrease of 3% compared with 2008. On an underlying basis, net earned insurance premiums increased by 3%. Growth was recorded in Asia, Brazil and France, but this was largely offset by significant declines in the UK and the US.

Net earned insurance premiums continued to grow in Asia, mainly from the launch of new products including a life insurance product designed for high net worth individuals and a guaranteed savings product. In Hong Kong, we retained our position as the leading bancassurer and increased net earned insurance premiums as a result of higher sales of unit-linked and whole life products.

Growth in insurance premiums in Asia, Brazil and France was largely offset by declines in the UK and US.

In Latin America, premium growth was driven by higher sales of pension and life products in Brazil, partly due to a number of customers switching their personal pension annuities to us.

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In France, growth was significantly influenced by a large one-off reinsurance transaction in June 2008, which passed insurance premiums to a third-party reinsurance provider. Adjusting for this, net earned insurance premiums were ahead of 2008 despite a significant reduction in the distribution network following the disposal of the French regional banks in July 2008.

In the UK, demand for the Guaranteed Income Bond savings product declined as HSBC offered more favourable rates on an alternative deposit product. As the deposit product was a savings bond rather than an insurance contract, its income was recorded under net interest income, while the associated fall in sales of insurance products led to a US\$1.1bn reduction in insurance premium income with an equivalent decrease in Net insurance claims incurred and movement in liabilities to policyholders, as described below.

The reduction in origination volumes in the consumer finance business in North America also led to correspondingly lower sales of credit protection insurance as the consumer finance business was closed.

Other operating income

Reported other operating income of US\$2.8bn was 54% higher than in 2008. This included a US\$280m gain related to the sale of the remaining stake in the card merchant-acquiring business in the UK, compared with a US\$425m gain in 2008 from the sale of the first tranche. In 2008, results also included gains of US\$71m related to the sale of our stake in Financiera Independencia. On an underlying basis, other operating income rose by 163%, driven mainly by an increase in insurance-related income in Hong Kong, a rise in gains on property disposals and lower losses on foreclosed properties.

Increased insurance income in Hong Kong, higher gains on property disposals and lower losses on foreclosed properties in the US helped drive an underlying US\$1.5bn rise in other operating income.

Losses recognised on assets held for sale declined as losses on foreclosed properties in HSBC Finance decreased, partly due to lower inventory levels following delays in the foreclosure process and partly due to some stabilisation in real estate prices.

Property gains of US\$576m were recognised in respect of the sale and leaseback of 8 Canada Square, London which was effected through the disposal of our entire shareholding in Project Maple II B.V. (PMII) to the National Pension Service of Korea.

In 2008, we reported a gain of US\$416m in respect of the purchase of PMII.

An increase in insurance sales to new customers in Hong Kong resulted in positive movements in the present value of in-force (PVIF) long-term insurance business. Further positive movements arose from refining the income recognition methodology used in respect of long-term insurance contracts in HSBC Finance. In 2008, a similar refinement in Brazil and our introduction of enhanced benefits to existing pension products in the UK, resulted in favourable movements in PVIF.

In Hong Kong, a gain of US\$110m was recognised in respect of a property disposal, and in Argentina a gain was realised on the sale of the head office building.

Other operating income includes higher gains on the sale of prime residential mortgage portfolios in the US, gains from the extinguishment of certain debt issued by our mortgage securitisation vehicles in the UK and lower costs associated with the provision of support to certain money market funds.

Net insurance claims incurred and movement in liabilities to policyholders

Reported net insurance claims incurred and movement in liabilities to policyholders increased by 81% to US\$12.5bn. On an underlying basis, they increased by 94%.

The increase in net insurance claims incurred and movement in liabilities to policyholders mainly reflected the improvement in investment market performance compared with 2008 described above under Financial instruments designated at fair value . Higher investment gains were broadly matched by movement in liabilities to policyholders on unit-linked and, to a certain extent, participating policies whose policyholders share in the investment performance of the supporting assets. The gains generated on the assets held to support insurance contract liabilities are reported in Net income from financial instruments designated at fair value .

New business growth in a number of regions during 2009, particularly Hong Kong and Singapore, also contributed to an increase in the movement in liabilities to policyholders, as did the non-recurrence of a large one-off reinsurance transaction in France in 2008. The decline in sales of a Guaranteed Income Bond noted above had a corresponding effect on movement in liabilities to policyholders in the UK.

As a consequence of a rising incidence and severity of claims, aggregate charges of US\$310m were made to strengthen reserves in the UK motor

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book and the Irish reinsurance business during 2009. The UK motor insurance business was placed into run-off in September 2009.

Loan impairment charges and other credit risk provisions

Reported loan impairment charges and other credit risk provisions were US\$26.5bn in 2009, an increase of 6% over 2008, 9% on an underlying basis. Within this, collectively assessed impairment allowances declined while individually assessed impairment allowances continued to increase.

Our aggregate outstanding customer loan impairment allowances at 31 December 2009 of US\$25.5bn represented 3% of gross customer advances (net of reverse repos and settlement accounts) compared with 2.6% at the end of 2008.

Loan impairment charges declined in certain businesses, notably PFS in North America and CMB in Hong Kong, but this was more than offset by increases elsewhere, primarily on individually significant loans within GB&M and more broadly on CMB exposures outside Hong Kong as the global economic downturn adversely affected the ability of many customers to service their loan commitments. As a consequence, loan impairment charges rose despite an underlying 9% decline in gross loans and advances to customers which was driven mainly by the run-off of the US consumer finance portfolios.

In our US PFS business, loan impairment charges declined by 11% to US\$14.2bn, as additional delinquencies due to the continued deterioration in the US economy were more than offset by the effect of lower balances in the run-off portfolios in HSBC Finance.

In HSBC Finance, loan impairment charges decreased by 12%. The reduction arose in most portfolios, but mainly in Mortgage Services as the portfolio continued to run off. In Consumer Lending, loan impairment charges increased, particularly in the unsecured personal lending portfolio, due to a deterioration in the 2006 and 2007 vintages and, to a lesser extent, first lien real estate secured loans, which was partly offset by lower loan impairment charges in the real estate secured portfolio. Loan impairment charges in the Card and Retail Services portfolio decreased despite the state of the US economy and higher levels of unemployment and personal bankruptcy. The main reason was the decline in card balances following actions taken to manage risk beginning in the fourth quarter of 2007 and continuing through 2009, and stable credit conditions.

In HSBC Bank USA, increased loan impairment charges in the personal lending portfolios were due to additional delinquencies which resulted in increased write-offs in the prime first lien mortgage loan portfolios as house prices continued to deteriorate in certain markets.

Loan impairment charges and other credit risk provisions increased significantly in GB&M. Loan impairment charges increased, reflecting the impairment of a small number of exposures in the financial and property sectors in Europe and the Middle East. Further impairments were also recognised in respect of certain asset-backed securities held in the available-for-sale portfolio, reflecting mark-to-market losses which we judged to be significantly in excess of the likely ultimate cash losses.

Loan impairment charges declined in PFS in the US but rose in CMB outside Hong Kong and in GB&M.

In the UK, loan impairment charges rose in both the CMB and PFS portfolios. However, despite the contraction in the economy, charges remained a low proportion of the portfolio. In CMB, loan impairment charges largely reflected economic weakness in a broad range of sectors.

In UK PFS, loan impairment charges also increased as unemployment rose. This was seen primarily in the credit card and unsecured personal loan portfolios. In the residential mortgage portfolios, delinquency rates decreased as we continued to benefit from very limited exposure to buy-to-let and self-certified mortgages. Our mortgage exposure continued to be well secured, with an average loan-to-value ratio for new UK business in HSBC Bank's mortgage

portfolio, excluding First Direct, of under 55% in 2009, compared with 59% in 2008.

In the Middle East, our loan impairment charges increased markedly from US\$280m to US\$1.3bn as the region experienced a significant economic contraction in activity, predominantly in real estate and construction, which particularly affected the UAE. CMB recorded a number of specific loan impairment charges and a significant increase in collective loan impairment charges. Lower employment in the region, largely driven by the decline in construction activity, led to a rise in loan impairment charges in PFS, particularly in the credit card and personal lending portfolios.

In Latin America, our portfolios were affected by the weaker economic environment for much of the year. In PFS, loan impairment charges rose by 12% to US\$2.0bn, with increased delinquencies in

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credit cards, mortgages, vehicle finance and payroll loans due to higher unemployment. In the Brazilian CMB portfolios, higher delinquencies were experienced primarily in the business banking and mid-market segments. In Mexico, action taken in 2008 to curtail originations and increase collection resources held loan impairment charges broadly unchanged notwithstanding the deterioration in the economy and the impact of the H1N1 virus.

In India, as in Mexico, curtailment of origination activity in unsecured personal lending slowed the increase in loan impairment charges in the unsecured credit card and personal lending portfolios in PFS. In CMB, a higher number of corporate failures including a number of fraud-related losses, led to increased loan impairment charges.

Loan impairment charges and other credit risk provisions in Hong Kong decreased by 35% to US\$500m as the economic environment improved in 2009, credit conditions recovered and international trade volumes improved.

In GPB, loan impairment charges increased from a very low level, largely attributable to a specific charge relating to a single client relationship in the US.

Operating expenses

Reported operating expenses fell by US\$14.7bn to US\$34.4bn, with the most significant feature being the non-recurrence of the goodwill impairment charge of US\$10.6bn in 2008 to fully write off goodwill in PFS in North America. Excluding this and on an underlying basis, operating expenses fell by 4%.

Underlying operating expenses excluding goodwill impairment fell by 4%.

Employee compensation and benefits fell by 4% as costs in the US declined following the closure of the branch-based consumer finance business in the first quarter of 2009. Average headcount in most regions was lower and this was reflected in lower costs. In the UK, a change in the basis of delivering death-in-service, ill health and early retirement benefits for some UK employees generated a one-off accounting gain of US\$499m which was partly offset by increased regular pension costs. There were higher performance-related costs in GB&M reflecting its results. The UK and French governments announced one-off taxes in late 2009 in respect of certain bonuses payable by banks and banking groups. In both countries there is uncertainty over the interpretation of the draft proposals, and detailed analysis of individual awards

in the context of the final legislation will be required to determine the precise effect of the taxes. The estimated tax payable under the proposals as currently drafted is US\$355m in the UK and US\$45m in France. The taxes will be payable and accounted for in 2010 once the legislation is enacted.

Premises and equipment costs increased marginally with higher rental costs reflecting the sale and leaseback of a number of properties in 2008. One-off costs incurred due to the closure of the Consumer Lending branch network in the US were partly offset by savings resulting from the closure.

General and administrative expenses fell as we focused on managing costs tightly and increasing efficiency. Marketing and advertising costs fell across the Group, most notably in Card and Retail Services in North America, and in the UK. Travel and entertainment costs, and expenditure related to services contracted to third parties, fell, primarily in Europe and North America. Better use of direct channels, increased automation of manual processes, enhanced utilisation of global service centres and elimination of redundant systems continued to be driven through our One HSBC programme. In North America, cost savings also resulted in the Consumer Lending Business from the discontinuation of loan originations and the closure of branches.

Share of profit in associates and joint ventures

The share of profit in associates and joint ventures was US\$1.8bn, an increase of 7% on 2008, and 6% on an underlying basis.

Our share of profits from Ping An Insurance increased by 62% as a result of the non-recurrence of its impairment of its investment in Fortis SA/NV and Fortis N.V. (Fortis) in 2008 and an increase in new business sales and investment returns which were boosted by a recovery in equity markets during 2009. This was partly offset by the non-recurrence of favourable changes to investment assumptions in the first half of 2008.

6% underlying increase in share of profit in associates and joint ventures.

Our share of profits from the Bank of Communications remained in line with 2008 as higher fee and trading income and a lower tax charge were broadly offset by a decline in net interest income and higher loan impairment charges.

Profits from The Saudi British Bank were lower than in 2008 as an increase in loan impairment charges was only partly offset by increased operating income.

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The share of profits from joint ventures fell due to a decline in the profitability of HSBC Saudi Arabia Ltd as a result of a slowdown in initial public offerings (IPO s) and a decline in assets under management. This was partly offset by an increase in profits from HSBC Merchant Services UK Ltd in the first half of 2009 compared with the second half of 2008. HSBC Merchant Services UK Ltd was created in June 2008 and sold in June 2009.

Tax expense

The most significant factor influencing the year on year changes to the effective tax rate is the changing geographical split of profits, including the relative proportion of tax on the share of profits in associates and joint ventures included within profit before tax. The impact of the tax on profit on associates and joint ventures included within pre-tax profits was a reduction in the effective tax rate of 7.1% in 2009 and 5.1% in 2008.

In 2009 the losses in HSBC s US operations were tax effected at the local tax rate of 35.4%, while the profits in the rest of the HSBC Group were taxed at their local rates which averaged 18.8%. The combination of these two rates produced an overall tax effect of 5.44%.

The tax expense and effective tax rate also fell in 2009 due to the non-recurrence of the US\$10.6bn goodwill impairment charge in North America which, for tax purposes, was non-deductible and hence increased the effective tax rate by some 16% in 2008.

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Report of the Directors: Operating and Financial Review (continued)**Consolidated balance sheet***Five-year summary consolidated balance sheet and selected financial information*

		At 31 December			
	2010	2009	2008	2007	2006
	US\$m	US\$m	US\$m	US\$m	US\$m
ASSETS					
Cash and balances at central banks	57,383	60,655	52,396	21,765	12,732
Trading assets	385,052	421,381	427,329	445,968	328,147
Financial assets designated at fair value	37,011	37,181	28,533	41,564	20,573
Derivatives	260,757	250,886	494,876	187,854	103,702
Loans and advances to banks	208,271	179,781	153,766	237,366	185,205
Loans and advances to customers ³⁵	958,366	896,231	932,868	981,548	868,133
Financial investments	400,755	369,158	300,235	283,000	204,806
Other assets	147,094	149,179	137,462	155,201	137,460
Total assets	2,454,689	2,364,452	2,527,465	2,354,266	1,860,758
LIABILITIES AND EQUITY					
Liabilities					
Deposits by banks	110,584	124,872	130,084	132,181	99,694
Customer accounts	1,227,725	1,159,034	1,115,327	1,096,140	896,834
Trading liabilities	300,703	268,130	247,652	314,580	226,608
Financial liabilities designated at fair value	88,133	80,092	74,587	89,939	70,211
Derivatives	258,665	247,646	487,060	183,393	101,478
Debt securities in issue	145,401	146,896	179,693	246,579	230,325
Liabilities under insurance contracts	58,609	53,707	43,683	42,606	17,670
Other liabilities	109,954	148,414	149,150	113,432	103,010
Total liabilities	2,299,774	2,228,791	2,427,236	2,218,850	1,745,830
Equity					
Total shareholders' equity	147,667	128,299	93,591	128,160	108,352
Non-controlling interests	7,248	7,362	6,638	7,256	6,576
Total equity	154,915	135,661	100,229	135,416	114,928

Total equity and liabilities	2,454,689	2,364,452	2,527,465	2,354,266	1,860,758
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Five-year selected financial information

Called up share capital	8,843	8,705	6,053	5,915	5,786
Capital resources ^{36,37}	167,555	155,729	131,460	152,640	127,074
Undated subordinated loan capital	2,781	2,785	2,843	2,922	3,219
Preferred securities and dated subordinated loan capital ³⁸	54,421	52,126	50,307	49,472	42,642

Risk weighted assets and capital ratios³⁶

Risk weighted assets	1,103,113	1,133,168	1,147,974	1,123,782	938,678
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	%	%	%	%	%
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Tier 1 ratio	12.1	10.8	8.3	9.3	9.4
Total capital ratio	15.2	13.7	11.4	13.6	13.5

Financial statistics

Loans and advances to customers as a percentage of customer accounts	78.1	77.3	83.6	89.5	96.8
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Average total shareholders' equity to average total assets	5.53	4.72	4.87	5.69	5.97
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Net asset value per ordinary share at year-end ³⁹ (US\$)	7.94	7.17	7.44	10.72	9.24
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Number of US\$0.50 ordinary shares in issue (millions)	17,686	17,408	12,105	11,829	11,572
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Closing foreign exchange translation rates to US\$:

US\$1: £	0.644	0.616	0.686	0.498	0.509
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US\$1:	0.748	0.694	0.717	0.679	0.759
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For footnotes, see page 83.

A more detailed consolidated balance sheet is contained in the Financial Statements on page 240.

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Report of the Directors: Operating and Financial Review (continued)**Movement in 2010**

Total assets amounted to US\$2.5 trillion, 4% higher than at 31 December 2009. Excluding the effect of currency movements, underlying total assets increased by 5%. This reflected higher mortgage lending in Hong Kong and the UK, strong demand for commercial loans and a rise in trading assets in North America and Asia as a result of customer demand, supported by improved liquidity generated by higher deposits and our debt issuance programme.

The Group's reported tier 1 ratio increased from 10.8% to 12.1% due to the contribution from profits attributable to shareholders for the year net of dividends paid, the issue of hybrid capital securities net of redemptions, and a reduction in the reported level of risk-weighted assets (RWAs). The latter was driven by a decline in some retail portfolio exposures in North America as a result of run-off, partly offset by the effect of lending growth in Asia. Market risk RWAs decreased as a result of reduced volatility and continuing exposure management. For more details of capital and RWAs, see page 177.

The following commentary is on an underlying basis.

Assets

Cash and balances at central banks decreased by 4% as a result of lower year-end cash balances in North America as excess liquidity was redeployed into highly-rated government debt securities. This was partly offset by higher year-end cash balances in Europe.

Trading assets fell by 6%, due to the deconsolidation of the Constant Net Asset Value (CNAV) funds totalling US\$44bn (see Note 43 on the Financial Statements). This was offset, in part, by higher issuance of and customer demand for government and government agency debt securities, particularly in North America and Asia, and an increase in holdings of equities to hedge derivative positions arising from a rise in client trading activity. Higher customer-driven trading volumes also resulted in an increase in reverse repo balances in North America; this was partly offset by a reduction in reverse repo balances in Europe due to market uncertainty.

Strong increase in loans and advances to customers and customer accounts, notably in Asia, drove balance sheet growth.

Financial assets designated at fair value grew by 3% due to an increase in volumes in equity funds and a rise in the fair value of equity securities held within the insurance business, particularly in Europe and Hong Kong, as market values recovered and client risk appetite returned. This was partly offset by the sale of European government debt securities by Balance Sheet Management.

Derivative assets rose by 8%. This was driven by increases in the fair value of interest rate contracts as a result of downward shifts of major yield curves, offset by higher netting from increased trading with clearing houses. The notional value of outstanding contracts also rose, reflecting an increase in the number of open transactions compared with 2009.

Loans and advances to banks increased by 16% due to higher placements with commercial and central banks in Europe and Latin America.

Loans and advances to customers grew by 8% as we targeted commercial loans and, in the improved economic conditions, demand grew from customers, notably in Asia. The increase in demand for credit, along with competitive pricing, also drove continued growth in mortgage lending in Hong Kong and the UK, though mortgage balances declined in North America as the Consumer Lending and Mortgage Services portfolios continued to run off and credit card lending fell.

Financial investments rose by 9%, mainly in North America and Europe, as Balance Sheet Management redeployed cash into available-for-sale treasury bills and government agency debt securities. This was partly offset by a decline in financial investments in Asia, as a result of disposals and debt securities that matured and were not replaced to support growth in commercial lending.

Liabilities

Deposits by banks decreased by 8%, reflecting a notable decline in central bank deposits in Europe which was partly offset by an increase in central bank deposits in Asia.

Customer accounts were 7% higher, driven by an overall increase in savings and current accounts across most regions, particularly in Asia and Europe. Growth in Premier and online savings contributed to a significant increase in current account balances as customers responded well to targeted promotional campaigns.

Trading liabilities increased by 16%. Higher repo balances in North America were reported as a result of increased trading volumes of treasury and corporate bonds driven by market volatility in the bond market. In Europe, short bond and equity

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positions used to hedge derivative transactions increased, reflecting higher client demand.

Financial liabilities designated at fair value rose by 12% due to debt issuances by HSBC entities in Europe during 2010.

Derivative businesses are managed within market risk limits and, as a consequence, the increase in the value of *derivative liabilities* broadly matched that of derivative assets.

Debt securities in issue were in line with 2009, as new issuances of medium-term notes by HSBC entities in Europe during 2010 were offset by lower funding requirements in North America as the consumer finance portfolios in run-off declined.

Liabilities under insurance contracts grew by 12%. This was driven by strong life insurance sales in Hong Kong following the launch of several new products, and gains on unit-linked products as investment market values improved.

Other liabilities were 26% lower than at 31 December 2009 due to the deconsolidation of the CNAV funds (see Trading assets above).

Equity

Total shareholders equity increased by 17%, driven by profits generated during the year and the issue of Perpetual Subordinated Capital Securities, a form of tier 1 hybrid capital securities, in June 2010. In addition, the negative balance on the available-for-sale reserve declined from US\$10.0bn at 31 December 2009 to US\$4.1bn at 31 December 2010, largely reflecting improvements in the market value of assets.

Reconciliation of reported and underlying assets and liabilities

	31 December 2010 compared with 31 December 2009						
	31 Dec 09 as reported US\$m	Currency Translation ⁴⁰ US\$m	31 Dec 09 at 31 Dec 10 exchange rates US\$m	Under- lying change US\$m	31 Dec 10 as reported US\$m	Reported change %	Under- lying change %
Cash and balances at central banks	60,655	(731)	59,924	(2,541)	57,383	(5)	(4)
Trading assets	421,381	(12,483)	408,898	(23,846)	385,052	(9)	(6)
Financial assets designated at fair value	37,181	(1,134)	36,047	964	37,011		3
Derivative assets	250,886	(9,285)	241,601	19,156	260,757	4	8
Loans and advances to banks	179,781	(5)	179,776	28,495	208,271	16	16
Loans and advances to customers	896,231	(10,788)	885,443	72,923	958,366	7	8
Financial investments	369,158	(268)	368,890	31,865	400,755	9	9
Other assets	149,179	(1,826)	147,353	(259)	147,094	(1)	

Total assets	2,364,452	(36,520)	2,327,932	126,757	2,454,689	4	5
Deposits by banks	124,872	(4,182)	120,690	(10,106)	110,584	(11)	(8)
Customer accounts	1,159,034	(8,064)	1,150,970	76,755	1,227,725	6	7
Trading liabilities	268,130	(8,660)	259,470	41,233	300,703	12	16
Financial liabilities designated at fair value	80,092	(1,570)	78,522	9,611	88,133	10	12
Derivative liabilities	247,646	(9,262)	238,384	20,281	258,665	4	9
Debt securities in issue	146,896	(1,066)	145,830	(429)	145,401	(1)	
Liabilities under insurance contracts	53,707	(1,593)	52,114	6,495	58,609	9	12
Other liabilities	148,414	(431)	147,983	(38,029)	109,954	(26)	(26)
Total liabilities	2,228,791	(34,828)	2,193,963	105,811	2,299,774	3	5
Total shareholders' equity	128,299	(1,679)	126,620	21,047	147,667	15	17
Non-controlling interests	7,362	(13)	7,349	(101)	7,248	(2)	(1)
Total equity	135,661	(1,692)	133,969	20,946	154,915	14	16
Total equity and liabilities	2,364,452	(36,520)	2,327,932	126,757	2,454,689	4	5

For footnote, see page 83.

In 2010, the effect of acquisitions was not material.

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Reconciliation of reported and underlying loans and advances to customers and customer accounts by geographical region

	31 December 2010 compared with 31 December 2009						
	31 Dec 09		31 Dec 09		Under-lying change	31 Dec 10	
	as reported	Currency translation ¹¹	exchange rates	at 31 Dec 10		as Reported	Under-lying change
	US\$m	US\$m	US\$m	US\$m	US\$m	%	%
Loans and advances to customers (net)							
Europe	439,481	(20,778)	418,703	17,096	435,799	(1)	4
Hong Kong	99,381	(92)	99,289	41,402	140,691	42	42
Rest of Asia-Pacific	80,043	5,802	85,845	22,886	108,731	36	27
Middle East	22,844	(139)	22,705	1,921	24,626	8	8
North America	206,853	2,562	209,415	(18,883)	190,532	(8)	(9)
Latin America	47,629	1,857	49,486	8,501	57,987	22	17
	896,231	(10,788)	885,443	72,923	958,366	7	8
Customer accounts							
Europe	495,019	(21,560)	473,459	18,104	491,563	(1)	4
Hong Kong	275,441	(474)	274,967	22,517	297,484	8	8
Rest of Asia-Pacific	133,999	8,938	142,937	15,218	158,155	18	11
Middle East	32,529	(320)	32,209	1,302	33,511	3	4
North America	149,157	2,259	151,416	7,070	158,486	6	5
Latin America	72,889	3,093	75,982	12,544	88,526	21	17
	1,159,034	(8,064)	1,150,970	76,755	1,227,725	6	7

Reconciliation of reported and underlying loans and advances to customers and customer accounts by customer groups and global businesses

	31 December 2010 compared with 31 December 2009						
	31 Dec 09		31 Dec 09		Under-lying	31 Dec 10	
	as	Currency	exchange	at 31 Dec 10		as Reported	Under-lying

	reported	translation ¹¹	rates	change	reported	change	change
	US\$m	US\$m	US\$m	US\$m	US\$m	%	%
Loans and advances to customers (net)							
Personal Financial Services	399,460	(2,176)	397,284	(6,327)	390,957	(2)	(2)
Commercial Banking	199,674	(1,493)	198,181	41,105	239,286	20	21
Global Banking and Markets	256,956	(6,622)	250,334	34,169	284,503	11	14
Global Private Banking	37,031	(431)	36,600	4,065	40,665	10	11
Other	3,110	(66)	3,044	(89)	2,955	(5)	(3)
	896,231	(10,788)	885,443	72,923	958,366	7	8
Customer accounts							
Personal Financial Services	499,109	(1,710)	497,399	27,785	525,184	5	6
Commercial Banking	267,388	(1,537)	265,851	20,156	286,007	7	8
Global Banking and Markets	284,727	(4,711)	280,016	28,437	308,453	8	10
Global Private Banking	106,533	(108)	106,425	705	107,130	1	1
Other	1,277	2	1,279	(328)	951	(26)	(26)
	1,159,034	(8,064)	1,150,970	76,755	1,227,725	6	7

For footnote, see page 83.

In 2010, the effect of acquisitions was not material.

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Report of the Directors: Operating and Financial Review (continued)**Average balance sheet****Average balance sheet and net interest income**

Average balances and related interest are shown for the domestic operations of our principal commercial banks by geographical region. Other operations comprise the operations of our 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 our 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

	2010			2009			2008		
	Average balance	Interest income	Yield	Average balance	Interest income	Yield	Average balance	Interest income	Yield
	US\$m	US\$m	%	US\$m	US\$m	%	US\$m	US\$m	%

Summary

Total interest-earning assets (itemised below)	1,472,294	58,345	3.96	1,384,705	62,096	4.48	1,466,622	91,301	6.23
Trading assets ⁶³	332,511	6,027	1.81	357,504	7,614	2.13	428,539	16,742	3.91
Financial assets designated at fair value ⁶⁴	52,692	1,033	1.96	62,143	1,032	1.66	37,303	1,108	2.97
Impairment provisions	(22,905)			(26,308)			(20,360)		
Non-interest-earning assets	664,308			667,942			596,885		
Total assets and interest income	2,498,900	65,405	2.62	2,445,986	70,742	2.89	2,508,989	109,151	4.35

Short-term funds and loans and advances to banks

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Europe	HSBC Bank	47,741	1,290	2.70	38,455	1,379	3.59	46,703	2,187	4.68
	HSBC Private Banking Holdings (Suisse)	2,603	15	0.58	4,451	43	0.97	8,040	333	4.14
	HSBC France	47,094	337	0.72	37,239	440	1.18	35,801	1,495	4.18
Hong Kong	Hang Seng Bank	14,884	222	1.49	16,626	202	1.21	17,402	587	3.37
	The Hongkong and Shanghai Banking Corporation	16,544	117	0.71	27,903	182	0.65	47,244	1,344	2.84
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	30,288	464	1.53	23,107	326	1.41	27,907	881	3.16
	HSBC Bank Malaysia	5,113	126	2.46	3,776	81	2.15	4,659	165	3.54
Middle East	HSBC Bank Middle East	5,335	60	1.12	4,312	52	1.21	6,028	188	3.12
North America	HSBC Bank USA	28,653	103	0.36	2,338	94	4.02	9,595	328	3.42
	HSBC Bank Canada	3,823	16	0.42	2,934	10	0.34	3,354	107	3.19
Latin America	HSBC Mexico	3,238	129	3.98	3,722	149	4.00	3,682	247	6.71
	Brazilian operations ⁶⁵	16,102	1,525	9.47	10,490	1,003	9.56	7,959	951	11.95
	HSBC Bank Panama	959	8	0.83	1,187	10	0.84	1,133	30	2.65
	HSBC Bank Argentina	169	20	11.83	256	29	11.33	612	43	7.03
Other operations		14,196	123	0.87	15,782	199	1.26	19,992	760	3.80
		236,742	4,555	1.92	192,578	4,199	2.18	240,111	9,646	4.02

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)

		2010			2009			2008		
		Average balance	Interest income	Yield	Average balance	Interest income	Yield	Average balance	Interest income	Yield
		US\$m	US\$m	%	US\$m	US\$m	%	US\$m	US\$m	%
Loans and advances to customers										
Europe	HSBC Bank	265,163	9,761	3.68	276,602	10,898	3.94	288,214	18,587	6.45
	HSBC Private Banking Holdings (Suisse)	11,987	191	1.59	9,993	176	1.76	12,355	494	4.00
	HSBC France	66,910	1,684	2.52	71,048	1,932	2.72	73,455	3,604	4.91
	HSBC Finance	2,251	198	8.80	3,094	319	10.31	4,808	505	10.50
Hong Kong	Hang Seng Bank	51,028	1,313	2.57	42,619	1,194	2.80	42,304	1,589	3.76
	The Hongkong and Shanghai Banking Corporation	65,226	1,755	2.69	55,287	1,757	3.18	54,628	2,291	4.19
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	81,080	3,928	4.84	66,262	3,668	5.54	77,741	5,163	6.64
	HSBC Bank Malaysia	9,614	531	5.52	8,113	455	5.61	8,407	553	6.58
Middle East	HSBC Bank Middle East	21,193	1,303	6.15	22,612	1,593	7.04	23,697	1,549	6.54
North America	HSBC Bank USA	78,556	4,582	5.83	98,422	5,541	5.63	93,088	5,758	6.19
	HSBC Finance	78,105	7,741	9.91	101,132	9,941	9.83	140,957	15,835	11.23
	HSBC Bank Canada	46,360	1,643	3.54	43,072	1,499	3.48	48,331	2,455	5.08
Latin America	HSBC Mexico	12,309	1,571	12.76	12,185	1,708	14.02	17,252	2,565	14.87
		23,366	5,118	21.90	18,704	4,494	24.03	19,642	4,879	24.84

	Brazilian operations ⁶⁵									
	HSBC Bank Panama	9,348	815	8.72	9,302	864	9.29	8,620	810	9.40
	HSBC Bank Argentina	2,460	367	14.92	1,940	357	18.40	2,136	378	17.70
	Other operations	33,543	1,685	5.02	29,670	1,905	6.42	28,027	1,707	6.09
		858,499	44,186	5.15	870,057	48,301	5.55	943,662	68,722	7.28
Financial investments										
Europe	HSBC Bank	85,206	1,725	2.02	79,763	2,321	2.91	83,725	3,840	4.59
	HSBC Private Banking Holdings (Suisse)	17,013	287	1.69	15,602	363	2.33	12,018	553	4.60
	HSBC France	4,017	102	2.54	5,327	141	2.65	14,862	795	5.35
Hong Kong	Hang Seng Bank	30,334	541	1.78	24,594	630	2.56	24,031	1,063	4.42
	The Hongkong and Shanghai Banking Corporation	65,256	477	0.73	52,965	644	1.22	15,361	563	3.67
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	37,833	1,161	3.07	34,056	1,039	3.05	31,992	1,507	4.71
	HSBC Bank Malaysia	911	28	3.07	1,218	37	3.04	937	36	3.84
Middle East	HSBC Bank Middle East	8,086	126	1.56	6,996	118	1.69	5,671	144	2.54
North America	HSBC Bank USA	38,541	1,156	3.00	27,253	969	3.56	25,089	1,232	4.91
	HSBC Finance	2,834	116	4.09	2,426	120	4.95	2,908	143	4.92
	HSBC Bank Canada	14,310	257	1.80	10,282	205	1.99	7,037	197	2.80
Latin America	HSBC Mexico	7,177	388	5.41	3,916	227	5.80	3,470	244	7.03
	Brazilian operations ⁶⁵	9,564	1,089	11.39	6,930	820	11.83	6,758	853	12.62
	HSBC Bank Panama	996	38	3.82	604	39	6.46	618	47	7.61

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HSBC Bank Argentina	370	58	15.68	181	35	19.34	287	47	16.38
Other operations	56,523	1,826	3.23	50,767	1,717	3.38	29,632	1,354	4.57
	378,971	9,375	2.47	322,880	9,425	2.92	264,396	12,618	4.77

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)*Assets (continued)*

		2010			2009			2008		
		Average balance	Interest income	Yield	Average balance	Interest income	Yield	Average balance	Interest income	Yield
		US\$m	US\$m	%	US\$m	US\$m	%	US\$m	US\$m	%
Other interest-earning assets										
Europe	HSBC Bank	14,255	100	0.70	17,406	188	1.08	25,885	630	2.43
	HSBC Private Banking Holdings (Suisse)	17,738	241	1.36	21,450	360	1.68	21,189	875	4.13
	HSBC France	9,954	93	0.93	11,867	172	1.45	23,414	630	2.69
Hong Kong	Hang Seng Bank	1,077	13	1.21	2,618	32	1.22	1,629	48	2.95
	The Hongkong and Shanghai Banking Corporation	27,112	260	0.96	26,657	214	0.80	33,571	949	2.83
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	18,476	55	0.30	19,917	106	0.53	24,492	352	1.44
	HSBC Bank Malaysia	745	14	1.88	407	6	1.47	212	7	3.30
Middle East	HSBC Bank Middle East	1,272	46	3.62	541	46	8.50	843	63	7.47
North America	HSBC Bank USA	3,467	58	1.67	3,327	71	2.13	3,091	188	6.08
		2,895	7	0.24	2,995	6	0.20	2,638	63	2.39

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	HSBC Finance HSBC Bank Canada	1,287	20	1.55	773	9	1.16	1,025	25	2.44
Latin America	HSBC Mexico	158	9	5.70	138			193	2	1.04
	Brazilian operations ⁶⁵	1,170	80	6.84	1,074	46	4.28	1,438	147	10.22
	HSBC Bank Panama	1,234	12	0.97	1,372	9	0.66	1,807	23	1.27
	HSBC Bank Argentina	87			51			58	1	1.72
Other operations		(102,845)	(779)		(111,403)	(1,094)		(123,032)	(3,688)	
		(1,918)	229	(11.94)	(810)	171	(21.11)	18,453	315	1.71
Total interest-earning assets										
Europe	HSBC Bank	412,365	12,876	3.12	412,226	14,786	3.59	444,527	25,244	5.68
	HSBC Private Banking Holdings (Suisse)	49,341	734	1.49	51,496	942	1.83	53,602	2,255	4.21
	HSBC France	127,975	2,216	1.73	125,481	2,685	2.14	147,532	6,524	4.42
	HSBC Finance	2,251	198	8.80	3,094	319	10.31	4,808	505	10.50
Hong Kong	Hang Seng Bank	97,323	2,089	2.15	86,457	2,058	2.38	85,366	3,287	3.85
	The Hongkong and Shanghai Banking Corporation	174,138	2,609	1.50	162,812	2,797	1.72	150,804	5,147	3.41
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	167,677	5,608	3.34	143,342	5,139	3.59	162,132	7,903	4.87
	HSBC Bank Malaysia	16,383	699	4.27	13,514	579	4.28	14,215	761	5.35

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Middle East	HSBC Bank Middle East	35,886	1,535	4.28	34,461	1,809	5.25	36,239	1,944	5.36
North America	HSBC Bank USA	149,217	5,899	3.95	131,340	6,675	5.08	130,863	7,506	5.74
	HSBC Finance	83,834	7,864	9.38	106,553	10,067	9.45	146,503	16,041	10.95
	HSBC Bank Canada	65,780	1,936	2.94	57,061	1,723	3.02	59,747	2,784	4.66
Latin America	HSBC Mexico	22,882	2,097	9.16	19,961	2,084	10.44	24,597	3,058	12.43
	Brazilian operations ⁶⁵	50,202	7,812	15.56	37,198	6,363	17.11	35,797	6,830	19.08
	HSBC Bank Panama	12,537	873	6.96	12,465	922	7.40	12,178	910	7.47
	HSBC Bank Argentina	3,086	445	14.42	2,428	421	17.34	3,093	469	15.16
Other operations		1,417	2,855		(15,184)	2,727		(45,381)	133	
		1,472,294	58,345	3.96	1,384,705	62,096	4.48	1,466,622	91,301	6.23

For footnotes, see page 83.

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)*Equity and liabilities*

	2010			2009			2008		
	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 %
Summary									
Total interest-bearing liabilities (itemised below)	1,339,390	18,904	1.41	1,353,283	21,366	1.58	1,451,842	48,738	3.36
Trading liabilities	258,348	3,497	1.35	205,670	3,987	1.94	277,940	11,029	3.97
Financial liabilities designated at fair value (excluding own debt issued)	17,456	283	1.62	15,688	293	1.87	21,266	345	1.62
Non-interest bearing current accounts	142,579			123,271			98,193		
Total equity and other non-interest bearing liabilities	741,127			748,074			659,747		
Total equity and liabilities	2,498,900	22,684	0.91	2,445,986	25,646	1.05	2,508,988	60,112	2.40

Deposits by banks⁶⁶

Europe	HSBC Bank	32,850	260	0.79	35,207	553	1.57	48,167	1,875	3.89
	HSBC Private Banking Holdings (Suisse)	964	2	0.21	1,063	1	0.09	4,493	105	2.34
	HSBC France	42,399	340	0.80	43,682	536	1.23	37,851	1,672	4.42
Hong Kong	Hang Seng Bank	1,456	4	0.27	1,051	5	0.48	1,696	55	3.24
	The Hongkong and Shanghai	5,691	10	0.18	6,892	9	0.13	3,665	70	1.91

	Banking Corporation									
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	9,540	131	1.37	10,710	165	1.54	16,232	450	2.77
	HSBC Bank Malaysia	164	4	2.44	110	2	1.82	338	10	2.96
Middle East	HSBC Bank Middle East	762	6	0.79	773	9	1.16	1,680	29	1.73
North America	HSBC Bank USA	8,693	26	0.30	8,381	9	0.11	11,015	220	2.00
	HSBC Bank Canada	946	5	0.53	1,405	8	0.57	1,391	41	2.95
Latin America	HSBC Mexico	1,002	51	5.09	1,462	49	3.35	822	32	3.89
	Brazilian operations ⁶⁵	3,610	247	6.84	3,292	241	7.32	2,790	190	6.81
	HSBC Bank Panama	612	18	2.94	908	26	2.86	1,016	43	4.23
	HSBC Bank Argentina	17	1	5.88	12	1	8.33	27	1	3.70
Other operations		2,737	31	1.13	2,899	45	1.55	4,564	166	3.64
		111,443	1,136	1.02	117,847	1,659	1.41	135,747	4,959	3.65

**Financial liabilities
designated at fair value
own debt issued⁶⁷**

Europe	HSBC Holdings	16,577	308	1.86	17,887	369	2.06	18,675	721	3.86
	HSBC Bank	15,169	270	1.78	7,932	196	2.47	8,805	529	6.01
	HSBC France	7,154	113	1.58	5,108	128	2.51	1,515	79	5.21
Hong Kong	Hang Seng Bank	63			130	2	1.54	127	6	4.72
North America	HSBC Bank USA	1,721	25	1.45	1,615	30	1.86	1,504	67	4.45
		24,740	528	2.13	26,628	871	3.27	32,126	1,563	4.87

HSBC
Finance

Other operations	1,282	27	2.11	921	(38)	(4.13)	1,083	168	15.51
	66,706	1,271	1.91	60,221	1,558	2.59	63,835	3,133	4.91

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)*Equity and liabilities (continued)*

		2010			2009			2008		
		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 %
Customer accounts⁶⁸										
Europe	HSBC Bank	275,153	2,042	0.74	274,949	2,407	0.88	305,702	10,092	3.30
	HSBC Private Banking Holdings (Suisse)	20,530	144	0.70	27,250	256	0.94	37,778	1,349	3.57
	HSBC France	50,096	377	0.75	61,465	645	1.05	39,428	1,583	4.01
Hong Kong	Hang Seng Bank	76,708	205	0.27	71,140	200	0.28	66,142	914	1.38
	The Hongkong and Shanghai Banking Corporation	160,794	146	0.09	150,520	211	0.14	139,169	1,365	0.98
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	104,648	1,696	1.62	92,305	1,494	1.62	96,476	2,869	2.97
	HSBC Bank Malaysia	11,213	220	1.96	9,658	191	1.98	10,266	295	2.87
Middle East	HSBC Bank Middle East	15,906	284	1.79	18,726	432	2.31	19,922	422	2.12
North America	HSBC Bank USA	85,946	540	0.63	85,007	975	1.15	86,701	2,069	2.39
	HSBC Bank Canada	41,153	304	0.74	35,051	385	1.10	34,090	967	2.84
Latin America	HSBC Mexico Brazilian operations ⁶⁵	14,127	398	2.82	11,636	391	3.36	14,612	561	3.84
		36,727	3,502	9.54	28,605	2,946	10.30	26,288	3,110	11.83
		8,771	321	3.66	8,592	353	4.11	7,761	296	3.81

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	HSBC Bank Panama HSBC Bank Argentina	2,538	97	3.82	2,151	99	4.60	2,266	145	6.40
Other operations		58,303	502	0.86	63,863	361	0.57	64,253	1,952	3.04
		962,613	10,778	1.12	940,918	11,346	1.21	950,854	27,989	2.94
Debt securities in issue										
Europe	HSBC Bank	62,735	1,130	1.80	72,955	1,305	1.79	86,216	4,001	4.64
	HSBC France	20,686	160	0.77	25,065	330	1.32	30,815	1,447	4.70
	HSBC Finance							215	8	3.72
Hong Kong	Hang Seng Bank	1,034	13	1.26	1,220	21	1.72	1,685	57	3.38
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	5,558	218	3.92	5,409	218	4.03	8,995	640	7.12
	HSBC Bank Malaysia	389	15	3.86	403	16	3.97	475	20	4.21
Middle East	HSBC Bank Middle East	3,940	63	1.60	2,988	62	2.07	2,650	90	3.40
North America	HSBC Bank USA	12,680	375	2.96	20,968	590	2.81	21,922	852	3.89
	HSBC Finance	48,561	1,766	3.64	63,563	2,510	3.95	98,096	3,765	3.84
	HSBC Bank Canada	13,205	343	2.60	12,825	322	2.51	16,957	604	3.56
Latin America	HSBC Mexico	922	51	5.53	1,460	67	4.59	2,693	243	9.02
	Brazilian operations ⁶⁵	2,112	151	7.15	1,568	86	5.48	1,859	156	8.39
	HSBC Bank Panama	771	40	5.19	487	34	6.98	556	33	5.94
	HSBC Bank Argentina	4			1			2		
Other operations		17,301	606	3.50	16,745	340	2.03	13,691	66	0.48
		189,898	4,931	2.60	225,657	5,901	2.62	286,827	11,982	4.18

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)

		2010			2009			2008		
		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 %
Other interest-bearing liabilities										
Europe	HSBC Bank	28,269	434	1.54	50,247	655	1.30	38,906	1,134	2.91
	HSBC Private Banking Holdings (Suisse)	2,921	7	0.24	3,892	18	0.46	4,203	135	3.21
	HSBC France	16,668	78	0.47	24,699	187	0.76	33,920	1,361	4.01
	HSBC Finance	1,595	15	0.94	2,363	59	2.50	3,712	191	5.15
Hong Kong	Hang Seng Bank	829	5	0.60	789	5	0.63	1,258	41	3.26
	The Hongkong and Shanghai Banking Corporation	8,580	55	0.64	12,815	105	0.82	10,557	288	2.73
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	34,027	248	0.73	19,447	177	0.91	23,685	466	1.97
	HSBC Bank Malaysia	706	8	1.13	266	2	0.75	338	7	2.07
Middle East	HSBC Bank Middle East	1,496	63	4.21	1,748	68	3.89	1,918	89	4.64
North America	HSBC Bank USA	14,669	609	4.15	9,754	368	3.77	10,490	468	4.46

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	HSBC Finance	3,487	102	2.93	4,051	102	2.52	4,670	141	3.02
	HSBC Bank Canada	1,806	3	0.17	1,149	6	0.52	1,306	19	1.45
	HSBC Markets Inc	1,266	25	1.97	1,716	36	2.10	10,349	78	0.75
Latin America	HSBC Mexico	804	13	1.62	301	11	3.65	187	20	10.70
	Brazilian operations ⁶⁵	2,803	316	11.27	1,496	130	8.69	2,340	207	8.85
	HSBC Bank Panama	108	1	0.93	192	2	1.04	917	3	0.33
	HSBC Bank Argentina	4			36	1	2.78	92	6	6.52
Other operations		(111,308)	(1,194)		(126,321)	(1,030)		(134,269)	(3,979)	
		8,730	788	9.03	8,640	902	10.44	14,579	675	4.63
Total interest-bearing liabilities										
Europe	HSBC Bank	414,176	4,136	1.00	441,290	5,116	1.16	487,796	17,631	3.61
	HSBC Private Banking Holdings (Suisse)	24,415	153	0.63	32,205	275	0.85	46,474	1,589	3.42
	HSBC France	137,003	1,068	0.78	160,019	1,826	1.14	143,529	6,142	4.28
	HSBC Finance	1,595	15	0.94	2,363	59	2.50	3,927	199	5.07
Hong Kong	Hang Seng Bank	80,090	227	0.28	74,330	233	0.31	70,908	1,073	1.51
	The Hongkong and Shanghai Banking Corporation	175,065	211	0.12	170,227	325	0.19	153,391	1,723	1.12
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	153,773	2,293	1.49	127,871	2,054	1.61	145,388	4,425	3.04

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	HSBC Bank Malaysia	12,472	247	1.98	10,437	211	2.02	11,417	332	2.91
Middle East	HSBC Bank Middle East	22,104	416	1.88	24,235	571	2.36	26,170	630	2.41
North America	HSBC Bank USA	123,709	1,575	1.27	125,725	1,972	1.57	131,632	3,676	2.79
	HSBC Finance	76,788	2,396	3.12	94,242	3,483	3.70	134,892	5,469	4.05
	HSBC Bank Canada	57,110	655	1.15	50,430	721	1.43	53,744	1,631	3.03
	HSBC Markets Inc	1,266	25	1.97	1,716	36	2.10	10,349	78	0.75
Latin America	HSBC Mexico	16,855	513	3.04	14,859	518	3.49	18,314	856	4.67
	Brazilian operations ⁶⁵	45,252	4,216	9.32	34,961	3,403	9.73	33,277	3,663	11.01
	HSBC Bank Panama	10,262	379	3.69	10,179	415	4.08	10,250	375	3.66
	HSBC Bank Argentina	2,563	98	3.82	2,200	101	4.59	2,387	152	6.37
Other operations	(15,108)	281		(24,006)	47		(32,003)	(906)		
		1,339,390	18,904	1.41	1,353,283	21,366	1.58	1,451,842	48,738	3.36

For footnotes, see page 83.

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Report of the Directors: Operating and Financial Review (continued)*Net interest margin⁶⁹*

		2010	2009	2008
		%	%	%
Total		2.68	2.94	2.90
Europe	HSBC Bank	2.12	2.35	1.71
	HSBC Private Banking Holdings (Suisse)	1.18	1.30	1.24
	HSBC France	0.90	0.68	0.26
	HSBC Finance	8.13	8.40	6.36
Hong Kong	Hang Seng Bank	1.91	2.11	2.59
	The Hongkong and Shanghai Banking Corporation	1.38	1.52	2.27
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	1.98	2.15	2.15
	HSBC Bank Malaysia	2.76	2.72	3.02
Middle East	HSBC Bank Middle East	3.12	3.59	3.63
North America	HSBC Bank USA	2.90	3.58	2.93
	HSBC Finance	6.52	6.18	7.22
	HSBC Bank Canada	1.95	1.76	1.93
Latin America	HSBC Mexico	6.92	7.85	8.95
	Brazilian operations ⁶⁵	7.16	7.96	8.85
	HSBC Bank Panama	3.94	4.07	4.39
	HSBC Bank Argentina	11.24	13.18	10.25

Distribution of average total assets

		2010	2009	2008
		%	%	%
Europe	HSBC Bank	37.5	36.7	36.7
	HSBC Private Banking Holdings (Suisse)	2.2	2.3	2.3
	HSBC France	12.9	15.0	13.8
	HSBC Finance	0.1		0.2
Hong Kong	Hang Seng Bank	4.5	4.2	3.9
	The Hongkong and Shanghai Banking Corporation	10.7	10.5	9.5

Rest of				
Asia-Pacific	The Hongkong and Shanghai Banking Corporation	9.4	8.5	8.8
	HSBC Bank Malaysia	0.7	0.6	0.6
Middle East	HSBC Bank Middle East	1.6	1.6	1.8
North America	HSBC Bank USA	9.7	11.0	11.2
	HSBC Finance	3.6	4.5	6.2
	HSBC Bank Canada	3.0	2.7	2.9
Latin America	HSBC Mexico	1.4	1.4	1.5
	Brazilian operations ⁶⁵	2.6	2.1	2.1
	HSBC Bank Panama	0.6	0.6	0.6
	HSBC Bank Argentina	0.2	0.2	0.2
Other operations (including consolidation adjustments)		(0.7)	(1.9)	(2.3)
		100.0	100.0	100.0

For footnotes, see page 83.

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)**Analysis of changes in net interest income and net interest expense**

The following tables allocate changes in net interest income and net interest expense between volume and rate for 2010 compared with 2009, and for 2009 compared with 2008.

Interest income

		Increase/(decrease) in 2010 compared with 2009			Increase/(decrease) in 2009 compared with 2008			
		2010 US\$m	Volume US\$m	Rate US\$m	2009 US\$m	Volume US\$m	Rate US\$m	2008 US\$m
Short term funds and loans and advances to banks								
Europe	HSBC Bank	1,290	333	(422)	1,379	(386)	(422)	2,187
	HSBC Private Banking Holdings (Suisse)	15	(18)	(10)	43	(149)	(141)	333
	HSBC France	337	116	(219)	440	60	(1,115)	1,495
Hong Kong	Hang Seng Bank	222	(21)	41	202	(26)	(359)	587
	The Hongkong and Shanghai Banking Corporation	117	(74)	9	182	(549)	(613)	1,344
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	464	101	37	326	(152)	(403)	881
	HSBC Bank Malaysia	126	29	16	81	(31)	(53)	165
Middle East	HSBC Bank Middle East	60	12	(4)	52	(54)	(82)	188
North America	HSBC Bank USA	103	1,058	(1,049)	94	(248)	14	328
	HSBC Bank Canada	16	3	3	10	(13)	(84)	107
Latin America	HSBC Mexico	129	(19)	(1)	149	3	(101)	247
	Brazilian operations ⁶⁵	1,525	537	(15)	1,003	302	(250)	951
	HSBC Bank Panama	8	(2)		10	1	(21)	30
	HSBC Bank Argentina	20	(10)	1	29	(25)	11	43
Other operations		123	(20)	(56)	199	(160)	(401)	760

		4,555	963	(607)	4,199	(1,911)	(3,536)	9,646
Loans and advances to customers								
Europe	HSBC Bank	9,761	(451)	(686)	10,898	(749)	(6,940)	18,587
	HSBC Private Banking							
	Holdings (Suisse)	191	35	(20)	176	(94)	(224)	494
	HSBC France	1,684	(113)	(135)	1,932	(118)	(1,554)	3,604
	HSBC Finance	198	(87)	(34)	319	(180)	(6)	505
Hong Kong	Hang Seng Bank	1,313	235	(116)	1,194	12	(407)	1,589
	The Hongkong and							
	Shanghai Banking							
	Corporation	1,755	316	(318)	1,757	28	(562)	2,291
Rest of	The Hongkong and							
Asia-Pacific	Shanghai Banking							
	Corporation	3,928	821	(561)	3,668	(762)	(733)	5,163
	HSBC Bank Malaysia	531	84	(8)	455	(19)	(79)	553
Middle East	HSBC Bank Middle							
	East	1,303	(100)	(190)	1,593	(71)	115	1,549
North								
America	HSBC Bank USA	4,582	(1,118)	159	5,541	330	(547)	5,758
	HSBC Finance	7,741	(2,264)	64	9,941	(4,472)	(1,422)	15,835
	HSBC Bank Canada	1,643	114	30	1,499	(267)	(689)	2,455
Latin America	HSBC Mexico	1,571	17	(154)	1,708	(753)	(104)	2,565
	Brazilian operations ⁶⁵	5,118	1,120	(496)	4,494	(233)	(152)	4,879
	HSBC Bank Panama	815	4	(53)	864	64	(10)	810
	HSBC Bank Argentina	367	96	(86)	357	(35)	14	378
Other operations		1,685	249	(469)	1,905	100	98	1,707
		44,186	(641)	(3,474)	48,301	(5,358)	(15,063)	68,722

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Report of the Directors: Operating and Financial Review (continued)*Interest income (continued)*

		Increase/(decrease) in 2010 compared with 2009			Increase/(decrease) in 2009 compared with 2008			
		2010 US\$m	Volume US\$m	Rate US\$m	2009 US\$m	Volume US\$m	Rate US\$m	2008 US\$m
Financial investments								
Europe	HSBC Bank	1,725	158	(754)	2,321	(182)	(1,337)	3,840
	HSBC Private Banking Holdings (Suisse)	287	33	(109)	363	165	(355)	553
	HSBC France	102	(35)	(4)	141	(510)	(144)	795
Hong Kong	Hang Seng Bank	541	147	(236)	630	25	(458)	1,063
	The Hongkong and Shanghai Banking Corporation	477	150	(317)	644	1,380	(1,299)	563
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	1,161	115	7	1,039	97	(565)	1,507
	HSBC Bank Malaysia	28	(9)		37	11	(10)	36
Middle East	HSBC Bank Middle East	126	18	(10)	118	34	(60)	144
North America	HSBC Bank USA	1,156	402	(215)	969	106	(369)	1,232
	HSBC Finance	116	20	(24)	120	(24)	1	143
	HSBC Bank Canada	257	80	(28)	205	91	(83)	197
Latin America	HSBC Mexico	388	189	(28)	227	31	(48)	244
	Brazilian operations ⁶⁵	1,089	312	(43)	820	22	(55)	853
	HSBC Bank Panama	38	25	(26)	39	(1)	(7)	47
	HSBC Bank Argentina	58	37	(14)	35	(17)	5	47
Other operations	1,826	195	(86)	1,717	966	(603)	1,354	
		9,375	1,638	(1,688)	9,425	2,790	(5,983)	12,618

For footnotes, see page 83.

Interest expense

		Increase/(decrease) in 2010 compared with 2009			Increase/(decrease) in 2009 compared with 2008			
		2010 US\$m	Volume US\$m	Rate US\$m	2009 US\$m	Volume US\$m	Rate US\$m	2008 US\$m
Deposits by banks								
Europe	HSBC Bank	260	(37)	(256)	553	(504)	(818)	1,875
	HSBC Private Banking Holdings (Suisse)	2		1	1	(80)	(24)	105
	HSBC France	340	(16)	(180)	536	258	(1,394)	1,672
Hong Kong	Hang Seng Bank	4	2	(3)	5	(21)	(29)	55
	The Hongkong and Shanghai Banking Corporation	10	(2)	3	9	62	(123)	70
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	131	(18)	(16)	165	(153)	(132)	450
	HSBC Bank Malaysia	4	1	1	2	(7)	(1)	10
Middle East	HSBC Bank Middle East	6		(3)	9	(16)	(4)	29
North America	HSBC Bank USA	26		17	9	(53)	(158)	220
	HSBC Bank Canada	5	(3)		8		(33)	41
Latin America	HSBC Mexico	51	(15)	17	49	25	(8)	32
	Brazilian operations ⁶⁵	247	23	(17)	241	34	17	190
	HSBC Bank Panama	18	(8)		26	(5)	(12)	43
	HSBC Bank Argentina	1			1	(1)	1	1
Other operations		31	(3)	(11)	45	(61)	(60)	166
		1,136	(90)	(433)	1,659	(653)	(2,647)	4,959

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Report of the Directors: Operating and Financial Review (continued)

		Increase/(decrease) in 2010 compared with 2009			Increase/(decrease) in 2009 compared with 2008			
		2010 US\$m	Volume US\$m	Rate US\$m	2009 US\$m	Volume US\$m	Rate US\$m	2008 US\$m
Customer accounts								
Europe	HSBC Bank	2,042	2	(367)	2,407	(1,015)	(6,670)	10,092
	HSBC Private Banking Holdings (Suisse)	144	(63)	(49)	256	(376)	(717)	1,349
	HSBC France	377	(119)	(149)	645	884	(1,822)	1,583
Hong Kong	Hang Seng Bank	205	16	(11)	200	69	(783)	914
	The Hongkong and Shanghai Banking Corporation	146	14	(79)	211	111	(1,265)	1,365
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	1,696	200	2	1,494	(124)	(1,251)	2,869
	HSBC Bank Malaysia	220	31	(2)	191	(17)	(87)	295
Middle East	HSBC Bank Middle East	284	(65)	(83)	432	(25)	35	422
North America	HSBC Bank USA	540	11	(446)	975	(40)	(1,054)	2,069
	HSBC Bank Canada	304	67	(148)	385	27	(609)	967
Latin America	HSBC Mexico	398	84	(77)	391	(114)	(56)	561
	Brazilian operations ⁶⁵	3,502	837	(281)	2,946	274	(438)	3,110
	HSBC Bank Panama	321	7	(39)	353	32	25	296
	HSBC Bank Argentina	97	18	(20)	99	(7)	(39)	145
Other operations		502	(32)	173	361	(12)	(1,579)	1,952
		10,778	263	(831)	11,346	(292)	(16,351)	27,989
Financial liabilities designated at fair value own debt issued		1,271	168	(455)	1,558	(177)	(1,398)	3,133

Debt securities in issue

Europe	HSBC Bank	1,130	(183)	8	1,305	(615)	(2,081)	4,001
	HSBC France	160	(58)	(112)	330	(270)	(847)	1,447
	HSBC Finance					(8)		8
Hong Kong	Hang Seng Bank	13	(3)	(5)	21	(16)	(20)	57
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	218	6	(6)	218	(255)	(167)	640
	HSBC Bank Malaysia	15	(1)		16	(3)	(1)	20
Middle East	HSBC Bank Middle East	63	20	(19)	62	11	(39)	90
North America	HSBC Bank USA	375	(233)	18	590	(37)	(225)	852
	HSBC Finance	1,766	(593)	(151)	2,510	(1,326)	71	3,765
	HSBC Bank Canada	343	10	11	322	(147)	(135)	604
Latin America	HSBC Mexico	51	(25)	9	67	(111)	(65)	243
	Brazilian operations ⁶⁵	151	30	35	86	(24)	(46)	156
	HSBC Bank Panama	40	20	(14)	34	(4)	5	33
Other operations		606	11	255	340	15	259	66
		4,931	(937)	(33)	5,901	(2,557)	(3,524)	11,982

For footnotes, see page 83.

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Report of the Directors: Operating and Financial Review (continued)**Short-term borrowings**

We include short-term borrowings within customer accounts, deposits by banks and debt securities in issue and do not show short-term borrowings separately on the balance sheet. Short-term borrowings are defined by the US Securities and

Exchange Commission as Federal funds purchased and securities sold under agreements to repurchase, commercial paper and other short-term borrowings. Our 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 table below.

Repos and short-term bonds

	2010 US\$	2009 US\$m	2008 US\$m
Securities sold under agreements to repurchase			
Outstanding at 31 December	159,256	152,218	145,180
Average amount outstanding during the year	175,955	170,671	177,256
Maximum quarter-end balance outstanding during the year	193,319	157,778	190,651
Weighted average interest rate during the year	0.5%	0.8%	3.8%
Weighted average interest rate at the year-end	0.9%	0.4%	2.9%
Short-term bonds			
Outstanding at 31 December	44,152	38,776	40,279
Average amount outstanding during the year	37,981	33,010	45,330
Maximum quarter-end balance outstanding during the year	44,152	38,776	55,842
Weighted average interest rate during the year	2.9%	3.2%	5.0%
Weighted average interest rate at the year-end	4.5%	0.6%	3.1%

Contractual obligations

The table below provides details of our material contractual obligations as at 31 December 2010.

	Payments due by period			
	Total US\$m	Less than 1 year US\$m	1 5 years US\$m	More than 5 years US\$m
Long-term debt obligations	236,144	71,913	90,284	73,947
Term deposits and certificates of deposit	207,805	193,131	10,643	4,031
Capital (finance) lease obligations	684	107	187	390
Operating lease obligations	6,257	943	2,700	2,614
Purchase obligations	1,071	657	414	

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Short positions in debt securities and equity shares	102,615	74,979	8,412	19,224
Current tax liability	1,804	1,804		
Pension/healthcare obligation	16,643	1,304	5,700	9,639
	573,023	344,838	118,340	109,845

Ratios of earnings to combined fixed charges (and preference share dividends)

	2010	2009	2008	2007	2006
Ratios of earnings to combined fixed charges and preference share dividends: ⁷⁰					
excluding interest on deposits	5.89	2.64	2.97	6.96	7.22
including interest on deposits	1.69	1.20	1.13	1.34	1.40
Ratios of earnings to combined fixed charges: ⁷⁰					
excluding interest on deposits	7.10	2.99	3.17	7.52	7.93
including interest on deposits	1.73	1.22	1.14	1.34	1.41

For footnote, see page 83.

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Report of the Directors: Operating and Financial Review (continued)**Loan maturity and interest sensitivity analysis**

At 31 December 2010, 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	Middle East US\$m	North America US\$m	Latin America US\$m	Total US\$m
Maturity of 1 year or less							
Loans and advances to banks	75,280	32,974	40,116	9,034	18,820	24,032	200,256
Commercial loans to customers							
Commercial, industrial and international trade	72,108	25,889	34,536	8,139	7,242	14,215	162,129
Real estate and other property related	16,040	10,739	5,753	1,635	5,892	1,851	41,910
Non-bank financial institutions	64,313	1,994	1,641	785	13,126	1,137	82,996
Governments	1,432	38	178	1,170	41	513	3,372
Other commercial	31,377	4,383	6,759	1,830	5,641	3,440	53,430
	185,270	43,043	48,867	13,559	31,942	21,156	343,837
Hong Kong Government Home Ownership Scheme Residential mortgages and other personal loans	29,904	15,337	12,161	2,819	31,174	9,190	100,585
Loans and advances to customers	215,174	58,750	61,028	16,378	63,116	30,346	444,792
	290,454	91,724	101,144	25,412	81,936	54,378	645,048
Maturity after 1 year but within 5 years							
Loans and advances to banks	2,499	204	285	234	626	487	4,335
Commercial loans to customers							
Commercial, industrial and international trade	29,641	6,920	6,178	2,371	7,859	6,086	59,055
Real estate and other property related	13,901	16,940	7,630	1,202	6,057	1,524	47,254
Non-bank financial institutions	4,866	748	362	540	6,689	1,161	14,366
Governments	309	2,188	159	165	40	843	3,704

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Other commercial	13,573	4,509	4,306	1,692	2,113	2,821	29,014
	62,290	31,305	18,635	5,970	22,758	12,435	153,393
Hong Kong Government Home Ownership Scheme Residential mortgages and other personal loans		1,228					1,228
	33,732	10,922	8,301	1,741	38,223	6,572	99,491
Loans and advances to customers	96,022	43,455	26,936	7,711	60,981	19,007	254,112
	98,521	43,659	27,221	7,945	61,607	19,494	258,447
Interest rate sensitivity of loans and advances to banks and commercial loans to customers							
Fixed interest rate	17,263	78	1,233	1,358	8,209	3,432	31,573
Variable interest rate	47,526	31,431	17,687	4,846	15,175	9,490	126,155
	64,789	31,509	18,920	6,204	23,384	12,922	157,728
Maturity after 5 years							
Loans and advances to banks	460	407	36	67	33	2,835	3,838
Commercial loans to customers							
Commercial, industrial and international trade	10,231	642	560	663	1,636	2,778	16,510
Real estate and other property related	7,089	7,231	775	33	1,928	498	17,554
Non-bank financial institutions	840	82	55	10	1,294	520	2,801
Governments	548	113	78	10	8	761	1,518
Other commercial	13,477	1,596	536	662	1,019	226	17,516
	32,185	9,664	2,004	1,378	5,885	4,783	55,899
Hong Kong Government Home Ownership Scheme Residential mortgages and other personal loans		1,939					1,939
	98,081	27,512	19,722	811	69,720	5,861	221,707
Loans and advances to customers	130,266	39,115	21,726	2,189	75,605	10,644	279,545
	130,726	39,522	21,762	2,256	75,638	13,479	283,383

Interest rate sensitivity of loans and
advances to banks and commercial
loans to customers

Fixed interest rate	8,326	412	108	855	1,669	2,369	13,739
Variable interest rate	24,319	9,659	1,932	590	4,249	5,249	45,998
	32,645	10,071	2,040	1,445	5,918	7,618	59,737

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Report of the Directors: Operating and Financial Review (continued)**Deposits**

The following tables summarise 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.

Deposits by banks

	2010		2009		2008	
	Average balance US\$m	Average rate %	Average balance US\$m	Average rate %	Average balance US\$m	Average rate %
Europe	85,973		87,677		99,228	
Demand and other non-interest bearing	8,298		6,415		5,231	
Demand interest bearing	13,783	0.6	14,259	1.0	19,204	3.2
Time	28,337	0.9	30,367	1.6	43,695	3.9
Other	35,555	0.8	36,636	1.3	31,098	4.4
Hong Kong	10,000		10,725		5,916	
Demand and other non-interest bearing	2,860		2,975		1,375	
Demand interest bearing	4,787	0.2	5,526	0.1	2,780	2.0
Time	1,803	0.3	1,637	0.3	1,583	2.7
Other	550	0.7	587	0.5	178	3.4
Rest of Asia-Pacific	11,476		12,467		18,203	
Demand and other non-interest bearing	1,746		1,605		1,546	
Demand interest bearing	4,937	1.2	4,097	1.2	4,317	2.3
Time	3,626	1.5	4,682	1.9	9,103	3.5
Other	1,167	2.0	2,083	1.4	3,237	3.8
Middle East	1,250		1,317		2,151	
Demand and other non-interest bearing	484		539		365	

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Demand interest bearing	9		18		15	
Time	685	0.6	691	1.2	1,239	2.7
Other	72	1.2	69	1.4	532	0.2
North America	13,324		13,203		14,835	
Demand and other non-interest bearing	2,493		1,755		761	
Demand interest bearing	3,386	0.1	4,770	0.1	5,684	1.7
Time	4,716	0.4	5,422	0.2	7,941	2.3
Other	2,729	0.5	1,256	0.7	449	1.6
Latin America	5,523		5,959		5,058	
Demand and other non-interest bearing	222		212		366	
Demand interest bearing	322	4.3	219	0.9	81	2.5
Time	2,246	5.5	4,171	5.0	3,357	5.6
Other	2,733	6.6	1,357	8.1	1,254	7.8
Total	127,546		131,348		145,391	
Demand and other non-interest bearing	16,103		13,501		9,644	
Demand interest bearing	27,224	0.6	28,889	0.7	32,081	2.7
Time	41,413	1.1	46,970	1.7	66,918	3.7
Other	42,806	1.3	41,988	1.6	36,748	4.5

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)*Customer accounts*

	2010		2009		2008	
	Average balance	Average rate	Average balance	Average rate	Average balance	Average rate
	US\$m	%	US\$m	%	US\$m	%
Europe	424,561		440,450		447,982	
Demand and other non-interest bearing	62,869		55,751		39,610	
Demand interest bearing	203,727	0.4	212,178	0.4	225,034	2.9
Savings	51,793	1.8	57,344	2.2	73,479	4.3
Time	60,140	1.2	67,045	1.4	83,208	3.8
Other	46,032	0.5	48,132	0.8	26,651	3.9
Hong Kong	280,733		261,703		236,109	
Demand and other non-interest bearing	27,412		22,056		15,620	
Demand interest bearing	202,330		171,846	0.1	126,199	0.4
Savings	37,119	0.5	45,537	0.6	65,068	2.4
Time	12,793	0.7	20,901	0.6	27,659	2.3
Other	1,079	0.2	1,363	0.1	1,563	1.2
Rest of Asia-Pacific	142,807		126,144		128,381	
Demand and other non-interest bearing	16,418		13,425		11,872	
Demand interest bearing	63,033	1.0	53,108	0.8	49,329	2.0
Savings	51,757	2.4	46,137	2.5	52,849	3.8
Time	10,734	0.9	12,542	1.2	13,342	3.3
Other	865	2.2	932	1.8	989	3.6
Middle East	32,747		33,211		35,546	
Demand and other non-interest bearing	11,873		9,865		10,849	
Demand interest bearing	6,315	1.5	6,364	1.4	6,324	1.6
Savings	13,774	2.8	15,005	3.4	16,119	3.1
Time	604	2.6	1,424	2.7	1,884	2.9
Other	181	0.1	553	0.2	370	0.5

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North America	157,361		145,820		144,982	
Demand and other non-interest bearing	22,235		18,350		16,759	
Demand interest bearing	28,569	0.2	25,870	0.2	18,261	1.6
Savings	78,040	0.8	69,296	1.4	87,001	2.5
Time	17,975	0.8	25,164	1.3	17,838	3.2
Other	10,542	0.6	7,140	0.8	5,123	2.4
Latin America	77,618		63,635		65,071	
Demand and other non-interest bearing	12,407		10,598		12,507	
Demand interest bearing	6,270	1.2	4,734	1.1	4,994	1.9
Savings	41,784	8.5	33,091	8.5	31,442	10.3
Time	15,716	3.9	14,244	4.8	15,179	5.2
Other	1,441	7.5	968	6.4	949	8.2
Total	1,115,827		1,070,963		1,058,071	
Demand and other non-interest bearing	153,214		130,045		107,217	
Demand interest bearing	510,244	0.3	474,100	0.3	430,141	1.9
Savings	274,267	2.5	266,410	2.6	325,958	3.9
Time	117,962	1.4	141,320	1.6	159,110	3.6
Other	60,140	0.7	59,088	0.9	35,645	3.6

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)*Certificates of deposit and other money market instruments*

	2010		2009		2008	
	Average balance US\$m	Average rate %	Average balance US\$m	Average rate %	Average balance US\$m	Average rate %
Europe	57,018	0.4	65,151	0.9	74,007	4.5
Hong Kong	213	3.8	278	3.6	745	3.0
Rest of Asia-Pacific	3,529	3.4	3,536	3.7	6,966	6.6
Middle East	68	0.5	265	6.4	648	4.6
North America	10,607	0.5	14,218	1.1	22,278	3.3
Latin America	1,126	4.0	1,227	3.6	3,036	7.8
	72,561	0.6	84,675	1.2	107,680	4.5

Certificates of deposit and other time deposits

The maturity analysis of certificates of deposit (CDs) and other wholesale time deposits is expressed by remaining maturity. The majority of CDs and time deposits are in amounts of US\$100,000 and over or the equivalent in other currencies.

	At 31 December 2010				
	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
Europe	98,113	14,977	15,726	7,587	136,403
Certificates of deposit	14,153	7,660	6,018		27,831
Time deposits:					
banks	25,183	2,530	1,671	2,221	31,605
customers	58,777	4,787	8,037	5,366	76,967
Hong Kong	12,420	564	1,289	722	14,995
Certificates of deposit	87	45	6	314	452
Time deposits:					

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banks	2,234	10	65	24	2,333
customers	10,099	509	1,218	384	12,210
Rest of Asia-Pacific	15,375	877	542	1,530	18,324
Certificates of deposit	3,347	370	373	559	4,649
Time deposits:					
banks	1,777	34	2	107	1,920
customers	10,251	473	167	864	11,755
Middle East	507	113	120	568	1,308
Certificates of deposit					
Time deposits:					
banks	364		2	340	706
customers	143	113	118	228	602
North America	12,220	1,979	1,977	1,152	17,328
Time deposits:					
banks	2,501	13	3	204	2,721
customers	9,719	1,966	1,974	948	14,607
Latin America	13,213	1,446	1,673	3,115	19,447
Certificates of deposit	183	53	447	382	1,065
Time deposits:					
banks	1,855	290	163	305	2,613
customers	11,175	1,103	1,063	2,428	15,769
Total	151,848	19,956	21,327	14,674	207,805
Certificates of deposit	17,770	8,128	6,844	1,255	33,997
Time deposits:					
banks	33,914	2,877	1,906	3,201	41,898
customers	100,164	8,951	12,577	10,218	131,910

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)**Economic profit**

Our internal performance measures include economic profit/(loss), a calculation which compares the return on financial capital invested in HSBC by our shareholders with the cost of that capital. We price our cost of capital internally and the difference between that cost and the post-tax profit attributable to ordinary shareholders represents the amount of economic profit/(loss) generated. Economic profit/(loss) generated is used by management as one input in deciding where to allocate capital and other resources.

In order to concentrate on external factors rather than measurement bases, we emphasise the trend in economic profit/(loss) ahead of absolute amounts within business units. Our long-term cost of capital is reviewed annually and for 2010 it was revised to 11% from the 10% used in 2009. We use a Capital Asset Pricing Model to determine our cost of capital. The main drivers of the increase were an increase in the risk free rate and an increase in the betas used in the calculation. The following commentary is on a reported basis.

Our economic loss decreased by US\$4.7bn to US\$3.3bn as a result of an increase in profit attributable to shareholders. This was predominantly driven by lower loan impairment charges across all regions and customer groups, notably in the US due to lower balances and decreased delinquency rates in Card and Retail Services, and the run-off of the Consumer Lending and mortgage services portfolio.

The increase in average invested capital reflected higher retained earnings and a significant decrease in reserves representing unrealised losses on available-for-sale securities due to a slowing in the rate of anticipated losses in the underlying collateral pools.

The return on invested capital increased by 4.6 percentage points, although it remained below our benchmark cost of capital. The economic spread improved by 3.6 percentage points, the result of an increase in return on invested capital, partly offset by the rise in the cost of capital in 2010.

	2010		2009	
	US\$m	%⁴¹	US\$m	% ⁴⁰
Average total shareholders' equity	138,224		115,431	
Adjusted by:				
Goodwill previously amortised or written off	8,123		8,123	
Property revaluation reserves	(813)		(799)	
Reserves representing unrealised losses on effective cash flow hedges	100		385	
Reserves representing unrealised losses on available-for-sale securities	6,129		16,189	
Preference shares and other equity instruments	(5,473)		(3,538)	
Average invested capital ⁴²	146,290		135,791	
Return on invested capital ⁴³	12,746	8.7	5,565	4.1

Benchmark cost of capital	(16,092)	(11.0)	(13,579)	(10.0)
Economic loss and spread	(3,346)	(2.3)	(8,014)	(5.9)

For footnotes, see page 83.

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)**Critical accounting policies***(Audited)***Introduction**

The results of HSBC are sensitive to the accounting policies, assumptions and estimates that underlie the preparation of our consolidated financial statements. The significant accounting policies 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 our results and financial position, in terms of the materiality of the items to which the policies are applied and the high degree of judgement involved, including the use of assumptions and estimation, are discussed below.

Impairment of loans and advances

Our accounting policy for losses arising from the impairment of customer loans and advances is described in Note 2g on the Financial Statements. Loan impairment allowances represent management's best estimate of losses incurred in the loan portfolios at the 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\$978bn (2009: US\$922bn), US\$15bn or 2% (2009: US\$15bn; 2%) were individually assessed for impairment, and US\$963bn or 98% (2009: US\$907bn; 98%) were collectively assessed for impairment.

The most significant judgemental area is the calculation of collective impairment allowances. The geographical area with most exposure to collectively assessed loans and advances is North America, which comprised US\$198bn or 21% (2009: US\$219bn; 24%) of the total. Collective impairment allowances in North America were US\$9bn, representing 64% (2009: US\$13bn; 68%) of the total collectively assessed loan impairment allowance.

The methods used to calculate collective impairment allowances on homogeneous groups of loans and advances that are not considered individually significant are disclosed in Note 2g on the Financial Statements. They 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.

The methods involve the use of statistically assessed historical information which 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, though sometimes it provides less relevant information about the inherent loss in a given portfolio at the balance sheet date, for example, when there have been changes in economic, regulatory or behavioural conditions which result in the most recent trends in portfolio risk factors being not fully reflected in the statistical models. In these circumstances, the risk factors are taken into account by adjusting the impairment allowances derived solely from historical loss experience.

Risk factors include loan portfolio growth, product mix, unemployment rates, bankruptcy trends, geographical 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 influences on customer payment patterns. Different factors are applied in different regions and countries to reflect local economic conditions, laws and regulations. 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.

However, the exercise of judgement requires the use of assumptions which are highly subjective and very sensitive to the risk factors, in particular to changes in economic and credit conditions across a large number of geographical areas. Many of the factors have a high degree of interdependency and there is no single factor to which our loan impairment allowances as a whole are sensitive. They are particularly sensitive to general economic and credit conditions in North America, however. For example, a 10% increase in impairment allowances on collectively assessed loans and advances in North America would increase loan impairment allowances by US\$0.9bn at 31 December 2010 (2009: US\$1.3bn). It is possible that the outcomes within the next

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Report of the Directors: Operating and Financial Review (continued)

financial year could differ from the assumptions built into the models, resulting in a material adjustment to the carrying amount of loans and advances.

Goodwill impairment

Our accounting policy for goodwill is described in Note 2p on the Financial Statements. Note 24 on the Financial Statements lists our cash generating units (CGUs) by geographical region and global business. HSBC's total goodwill amounted to US\$22bn at 31 December 2010 (2009: US\$23bn).

The review of goodwill impairment reflects management's best estimate of the following factors:

the future cash flows of the CGUs 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, but they necessarily and appropriately reflect management's view of future business prospects at the time of the assessment; and

the rates used to discount future expected cash flows are based on the costs of capital assigned to individual CGUs and can have a significant effect on their 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 for the inherent risk of the business being evaluated. These variables are subject to fluctuations in external market rates and economic conditions beyond our control and therefore require the exercise of significant judgement and are consequently subject to uncertainty.

A decline in a CGU's expected cash flows and/or an increase in its cost of capital reduces the CGU's estimated recoverable amount. If this is lower than the carrying value of the CGU, a charge for impairment of goodwill is recognised in our income statement for the year.

The accuracy of forecast cash flows is subject to a high degree of uncertainty in volatile market conditions. In such market conditions, management retests goodwill for impairment more frequently than annually to ensure that the assumptions on which the cash flow forecasts are based continue to reflect current market conditions and management's best estimate of future business prospects.

During 2010, no impairment of goodwill was identified (2009: nil). In addition to the annual impairment test which was performed as at 1 July 2010, management reviewed the current and expected performance of the CGUs as at 31 December 2010 and determined that there was no indication of potential impairment of the goodwill allocated to them. However, in the event of a significant deterioration in economic and credit conditions compared with those reflected by management in the cash flow forecasts for the CGUs, a material adjustment to a CGU's recoverable amount may occur which may result in the recognition of an impairment charge in the income statement.

Note 24 on the Financial Statements includes details of the CGUs with significant balances of goodwill, states the key assumptions used to assess the goodwill in each of those CGUs for impairment and provides a discussion of the sensitivity of the carrying value of goodwill to changes in key assumptions.

Valuation of financial instruments

Our accounting policy for determining the fair value 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. In the event that 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 unobservable. Valuation techniques that rely to a greater extent on unobservable 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 are discussed in Note 16 on the Financial Statements. The main assumptions and estimates which management consider 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 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;

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selecting an appropriate discount rate for the instrument. The determination of this rate is based on an 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 unobservable data are inherently uncertain because there is 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 is 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 are based on some market observable inputs even when unobservable inputs are significant.

The value of financial assets and liabilities measured at fair value using a valuation technique was US\$599bn (2009: US\$599bn) and US\$499bn (2009: US\$447bn), respectively or 56% (2009: 56%) of total financial assets and 77% (2009: 75%) of total financial liabilities measured at fair value.

Disclosures of the types and amounts of adjustments made in determining the fair value of financial instruments measured at fair value using valuation techniques, and a sensitivity analysis of fair values for financial instruments with significant unobservable inputs to reasonably possible alternative assumptions can be found in Note 16 on the Financial Statements. Given the uncertainty and subjective nature of valuing financial instruments at fair value, it is possible that the outcomes in the next financial year could differ from the assumptions used, and this could result in a material adjustment to the carrying amount of financial instruments measured at fair value.

Impairment of available-for-sale financial assets

Our accounting policy for impairment of available-for-sale financial assets is described in Note 2j on the Financial Statements.

At 31 December 2010, our total available-for-sale financial assets amounted to US\$381bn (2009: US\$352bn), of which US\$373bn or 98% (2009: US\$342bn; 97%) were debt securities. The available-for-sale fair value reserve relating to debt securities amounted to a deficit of US\$6.2bn (2009: deficit of US\$11.4bn). A deficit in the available-for-sale fair value reserve occurs on debt securities when the fair value of a relevant security is less than its acquisition cost (net of any principal repayments and amortisation) after deducting any previous impairment loss recognised in the income statement, but where there is no evidence of any impairment or, if an impairment was previously recognised, any subsequent impairment.

Management is required to exercise judgement in determining whether there is objective evidence that an impairment loss has occurred. Once an impairment has been identified, the amount of impairment loss is measured with reference to the fair value of the asset. More information on assumptions and estimates requiring management judgement relating to the determination of fair values of financial instruments is provided above in Valuation of financial instruments .

Deciding whether an available-for-sale debt security is impaired requires objective evidence of both the occurrence of a loss event and a related decrease in estimated future cash flows. The degree of judgement involved is less when cash flows are readily determinable, but increases when estimating future cash flows requires consideration of a number of variables, some of which may be unobservable in current market conditions.

There is no single factor to which the Group's charge for impairment of available-for-sale debt securities is particularly sensitive, because of the various types of securities we hold, the range of geographical areas in which

those securities are held, and the wide range of factors which can affect the occurrence of loss events and the cash flows of securities, including different types of collateral.

The most significant judgements concern more complex instruments, such as ABSs, where it is necessary to consider factors such as the estimated future cash flows on underlying pools of collateral including prepayment speeds, the extent and depth of market price declines and changes in credit ratings. The review of estimated future cash flows on underlying collateral is subject to uncertainties when the assessment is based on historical information on pools of assets, and judgement is required to determine whether historical performance remains

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Report of the Directors: Operating and Financial Review (continued)

representative of current economic and credit conditions.

Further details of the nature and extent of our exposures to ABSs classified as available-for-sale and a more detailed description of the assumptions and estimates used in assessing these securities for impairment, together with a discussion of those assets which are most sensitive to possible future impairment, are provided in *Securitisation exposures and other structured products* on page 128.

It is possible that outcomes in the next financial year could be different from those modelled when seeking to identify impairment on available-for-sale debt securities. In this event, impairment may be identified in available-for-sale debt securities which had previously been determined not to be impaired, potentially resulting in the recognition of material impairment losses in the next financial year.

Deferred tax assets

Our accounting policy for the recognition of deferred tax assets is described in Note 2s on the Financial Statements. The recognition of a deferred tax asset relies on an assessment of the probability and sufficiency of future taxable profits, future reversals of existing taxable temporary differences and ongoing tax planning strategies.

The most significant judgements concern the US deferred tax assets, given the recent history of losses in our US operations. Net US deferred tax assets amounted to US\$4bn or 58% (2009: US\$5.1bn; 59%) of deferred tax assets recognised on the Group's balance sheet.

Recognition of US deferred tax assets is based on the evidence available about conditions at the balance sheet date, and requires significant judgements to be made regarding projections of loan impairment charges and the timing of recovery in the US economy. These judgements take into consideration the effect of both positive and negative evidence, including historical financial performance, projections of future taxable income, future reversals of existing taxable temporary differences, tax planning strategies and the availability of loss carrybacks.

Projections of future taxable income in the US are based on business plans, future capital requirements and ongoing tax planning strategies. These projections include assumptions about future house prices, US economic conditions, including unemployment levels and their impact on loan impairment charges, and capital support from HSBC Holdings. These forecasts are consistent with the assumption that it is probable that the results of future operations will generate sufficient taxable income to support the deferred tax assets. In management's judgement, recent market conditions, which have resulted in losses being incurred in the US, will create significant downward pressure and volatility regarding the profit or loss before tax in the next few years. To reflect this, the assessment of recoverability of the deferred tax assets in the US significantly discounts any future expected taxable income and relies to a greater extent on capital support to the US operations from HSBC Holdings, including tax planning strategies implemented in relation to such support.

The most significant tax planning strategy is the investment of capital in our US operations to ensure the realisation of the deferred tax assets. The transfer of a subsidiary as part of an internal reorganisation on 31 January 2010 provided substantial support for the recoverability of the US deferred tax assets. Management expects that, with support, our US operations will continue to execute their business strategies and plans until they return to profitability. If HSBC Holdings were to decide not to provide ongoing support, the full recovery of the deferred tax asset may no longer be probable and could result in a significant reduction of the deferred tax asset which would be recognised as a charge in the income statement.

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Basis of preparation

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

Summary

HSBC's senior management reviews operating activity on a number of bases, including by geographical region and by customer group and global business. Capital resources are allocated and performance is assessed primarily by geographical region, as presented on page 50.

The commentaries below present customer groups and global businesses followed by geographical regions. Performance is discussed in this order because certain strategic themes, business initiatives and trends affect more than one geographical region. All commentaries are on an underlying basis (see page 14) unless

stated otherwise. All references to HSBC Finance and HSBC Bank USA are also on a management basis as loans referred to HSBC Bank USA from HSBC Finance are managed by the latter and all costs and benefits accrue thereto.

Profit/(loss) before tax

	2010		2009		2008	
	US\$m	%	US\$m	%	US\$m	%
Personal Financial Services	3,518	18.5	(2,065)	(29.2)	(10,974)	(117.9)
Commercial Banking	6,090	32.0	4,275	60.4	7,194	77.3
Global Banking and Markets	9,536	50.1	10,481	148.1	3,483	37.4
Global Private Banking	1,054	5.5	1,108	15.6	1,447	15.6
Other ⁴⁴	(1,161)	(6.1)	(6,720)	(94.9)	8,157	87.6
	19,037	100.0	7,079	100.0	9,307	100.0

Total assets⁴⁵

	At 31 December			
	2010		2009	
	US\$m	%	US\$m	%
Personal Financial Services	527,698	21.5	554,074	23.4
Commercial Banking	296,797	12.1	251,143	10.6
Global Banking and Markets	1,758,315	71.6	1,683,672	71.2
Global Private Banking	116,846	4.8	116,148	4.9
Other	161,458	6.6	150,983	6.4
Intra-HSBC items	(406,425)	(16.6)	(391,568)	(16.5)
	2,454,689	100.0	2,364,452	100.0

For footnotes, see page 83.

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Report of the Directors: Operating and Financial Review (continued)

Products and services

Products and services

Personal Financial Services

PFS offers its products and services to customers based on their individual needs. Premier and Advance services are targeted at mass affluent and emerging affluent customers who value international connectivity and benefit from our global reach and scale. For customers who have simpler everyday banking needs, we offer a full range of banking products and services reflecting local requirements.

In addition, we are one of the largest card issuers in the world, offering HSBC branded cards, co-branded cards with selected partners and private label (store) cards.

Typically, customer offerings include personal banking products (current and savings accounts, mortgages and personal loans, credit cards, debit cards and local and international payment services) and wealth management services (insurance and investment products and financial planning services).

Commercial Banking

We segment our CMB business into Corporate, to serve both Corporate and Mid-Market companies with more sophisticated financial needs and Business Banking, to serve the small and medium-sized enterprises (SMEs) sector. This enables the development of tailored customer propositions while adopting a broader view of the entire commercial banking sector, from sole

HSBC Premier provides preferential banking services and global recognition to our high net worth customers and their immediate families with a dedicated relationship manager, specialist wealth advice and tailored solutions. Customers can access emergency travel assistance, priority telephone banking and an online global view of their Premier accounts around the world with free money transfers between them.

HSBC Advance provides a range of preferential products and services customised to meet local needs. With a dedicated telephone service, access to wealth advice and online tools to support financial planning, it gives customers an online global view of their Advance accounts with money transfers between them.

Wealth Solutions & Financial Planning: a financial planning process designed around individual customer needs to help our clients to protect, grow and manage their wealth through best-in-class investment and wealth insurance products manufactured by in-house partners (Global Asset Management, Global Markets and HSBC Insurance) and by selected third party providers.

Customers can transact with the bank via a range of channels such as internet banking and self-service terminals in addition to traditional and automated branches and telephone service centres.

Financing: we offer a broad range of financing, both domestic and cross-border, including overdrafts, receivables finance, term loans and syndicated, leveraged, acquisition and project finance. Asset finance is offered in selected sites, focused on leasing and instalment finance for vehicles, plant and equipment.

Payments and cash management: we are a leading provider of domestic and cross-border payments and collections, liquidity management and account

proprietors to large corporations. This allows us to provide continuous support to companies as they expand both domestically and internationally, and ensures a clear focus on the business banking segments, which are typically the key to innovation and growth in market economies.

We place particular emphasis on international connectivity to meet our business customers' needs and aim to be recognised as the leading international bank in all our markets and the best bank for business in our largest markets.

services worldwide, delivered through our e-platform, HSBC net.

International trade: we provide various international trade products and services, to both buyers and suppliers such as export finance, guarantees, documentary collections and forfaiting to improve efficiency and help mitigate risk throughout the supply chain.

Treasury: CMB customers are volume users of our foreign exchange, derivatives and structured products.

Capital markets & advisory: capital raising on debt and equity markets and advisory services are available as required.

Commercial cards: card issuing helps customers enhance cash management, credit control and purchasing. Card acquiring services enable merchants to accept credit and debit card payments in person or remotely.

Insurance: CMB offers key person, employee benefits and a variety of commercial risk insurance such as property, cargo and trade credit.

Direct channels: these include online and direct banking offerings such as telephone banking, HSBCnet and Business Internet Banking.

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)**Global Banking and Markets**

GB&M provides tailored financial solutions to major government, corporate and institutional clients and private investors worldwide. Managed as a global business, GB&M operates a long-term relationship management approach to build a full understanding of clients' financial requirements. Sector-focused client service teams comprising relationship managers and product specialists develop financial solutions to meet individual client needs. With dedicated offices in over 65 countries and access to HSBC's worldwide presence and capabilities, this business serves subsidiaries and offices of our clients on a global basis.

GB&M is managed as four principal business lines: Global Markets, Global Banking, Global Asset Management and Principal Investments. This structure allows us to focus on relationships and sectors that best fit the Group's footprint and facilitate seamless delivery of our products and services to clients.

Global Private Banking

HSBC Private Bank is the principal marketing name of our international private banking business, Global Private Banking (GPB). Utilising the most suitable products from the marketplace, GPB works with its clients to offer both traditional and innovative ways to manage and preserve wealth while optimising returns.

GPB accesses expertise in six major advisory centres in Hong Kong, Singapore, Geneva, New York, Paris and London to identify opportunities which meet clients' needs and investment strategies.

Global Markets operations consist of treasury and capital markets services. Products include foreign exchange; currency, interest rate, bond, credit, equity and other derivatives; government and non-government fixed income and money market instruments; precious metals and exchange-traded futures; equity services; distribution of capital markets instruments; and securities services, including custody and clearing services and funds administration to both domestic and cross-border investors.

Global Banking offers financing, advisory and transaction services. Products include:

- capital raising, 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 trade services for large corporate clients.

Global Asset Management offers investment solutions to institutions, financial intermediaries and individual investors globally.

Principal Investments includes our strategic relationships with third-party private equity managers and other investments.

Private Banking services comprise multi-currency deposit accounts and fiduciary deposits, credit and specialist lending, treasury trading services, cash management, securities custody and clearing. GPB works to ensure that its clients have full access to other products and services available in HSBC such as credit cards, internet banking, corporate banking and investment banking.

Private Wealth Management comprises 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 alternatives (hedge funds,

private equity and real estate).

Corporate Finance Solutions helps provide clients with cross border solutions for their companies, working in conjunction with GB&M.

Private Wealth Solutions comprise inheritance planning, trustee and other fiduciary services designed to protect wealth and preserve it for future generations through structures tailored to meet the individual needs of each family. Areas of expertise include trusts, foundation and company administration, charitable trusts and foundations, insurance, family office advisory and philanthropy.

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)**Personal Financial Services**

PFS provides 92 million individual and self-employed customers with financial services in over 60 markets worldwide.

	2010 US\$m	2009 US\$m	2008 US\$m
Net interest income	24,161	25,107	29,419
Net fee income	7,336	8,238	10,107
Other income	1,079	2,070	1,963
Net operating income ⁴⁶	32,576	35,415	41,489
Impairment charges ⁴⁷	(11,259)	(19,902)	(21,220)
Net operating income	21,317	15,513	20,269
Total operating expenses	(18,805)	(18,292)	(31,704)
Operating profit/(loss)	2,512	(2,779)	(11,435)
Income from associates ⁴⁸	1,006	714	461
Profit/(loss) before tax	3,518	(2,065)	(10,974)

**Return to profitability in PFS
as credit quality
improved
HSBC Advance
launched in
34
markets in its first year
Significant increase
in mortgage lending
in Hong Kong and the UK**

Strategic direction

Our strategy for PFS is to use our global reach and scale to grow profitably in selected markets by providing relationship banking and wealth management services. PFS employs two globally consistent propositions in Premier and Advance and focuses on deepening customer relationships and increasing the penetration of wealth management services. In markets where we already have scale or where scale can be built over time, we provide services to all customer segments. In other markets, we participate more selectively, targeting mass affluent customers which have

strong international connectivity or where our global scale is crucial.

For footnotes, see page 83.

Review of performance

PFS reported a profit before tax of US\$3.5bn compared with a reported and underlying loss of US\$2.1bn in 2009. This was largely attributable to a decline in loan impairment charges in the US and the managed reduction of certain higher risk portfolios in Latin America, Asia and the Middle East. Performance improved in all regions as the credit quality of our lending portfolios generally rose and revenue grew in Asia and Europe, reflecting higher investment-related income, increased insurance revenue in Hong Kong and mortgage lending growth combined with wider spreads in the UK. Income from associates, particularly Ping An Insurance, increased, driven by strong sales growth.

Revenue fell, largely in HSBC Finance, due to lower lending balances in both the run-off portfolio and in the Card and Retail Services business. Card fees also decreased in North America following the implementation of the CARD Act. Revenue was further affected by an adverse fair value movement related to the non-qualifying hedges recorded in HSBC Finance compared with a favourable movement in 2009, as long-term interest rates declined.

We continued to invest in our business by hiring new relationship managers, investing in systems and infrastructure and developing our product offerings. Operating expenses remained broadly unchanged as a rise in costs in Asia from increased headcount and higher marketing expenditure in support of business expansion was broadly offset by strict cost control across the Group and lower costs associated with the reduced scope of the business in the US.

Loan impairment charges and other credit risk provisions fell by 44% in the improved economic conditions, reflecting a decline in lending balances, enhanced collection processes and tighter lending criteria. The decline in lending was significant in the US as the run-off of the non-core portfolio continued and balances fell in the Card and Retail Services business, where there were fewer active accounts and customers reduced their credit card debt. In addition, certain higher risk portfolios in Latin America, Asia and the Middle East were managed down and repositioned to higher quality assets, resulting in an improvement in credit quality.

In the UK, we increased our market share of mortgage lending, while maintaining a conservative loan to value ratio on new business. We grew mortgage lending in Asia,

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)

significantly in Hong Kong, where the introduction of HIBOR-linked mortgages drove volume growth and enabled us to maintain our market leadership. In Australia, Singapore and Malaysia we were able to grow mortgage volumes through targeted marketing campaigns. Customer account balances also grew, largely on the back of increased customer numbers in Asia and the UK.

HSBC Premier, our flagship global customer proposition, was available in 47 markets and had grown to 4.4m customers at the end of 2010. We attracted over 980,000 net new customers in 2010, of whom over 50% were new to HSBC.

We made further progress in standardising our various offerings across the Group for emerging mass affluent customers with the continued transition of eligible customers to HSBC Advance, our second globally consistent proposition. At 31 December 2010, Advance had a customer base of 4.6m and was available in 34 markets. During 2010, HSBC's Global View and Global Transfer online capabilities were extended to our Advance customer base. These services allow Premier and Advance customers to access and manage all their accounts through one single logon and transfer funds between their overseas accounts online. Both the volume and the value of transfers increased strongly during the year as our target customer base and general awareness of these services grew.

Our World Selection global investment offering continued to grow and is now available in 26 markets with total assets under management of US\$7.2bn at 31 December 2010.

We further enhanced our services and made banking easier for our customers with initiatives such as increased Saturday branch opening in the UK, the launch of retail renminbi wealth management products, mobile banking and online real time bond trading in Hong Kong, and the upgrading of the US automatic teller machine (ATM) network to accept deposits.

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)**Commercial Banking**

CMB offers a full range of commercial financial services and tailored propositions to 3.6m customers ranging from sole proprietors to publicly quoted companies in 65 countries.

	2010	2009	2008
	US\$m	US\$m	US\$m
Net interest income	8,487	7,883	9,494
Net fee income	3,964	3,702	4,097
Other income	1,383	1,268	1,726
Net operating income ⁴⁶	13,834	12,853	15,317
Impairment charges ⁴⁷	(1,805)	(3,282)	(2,173)
Net operating income	12,029	9,571	13,144
Total operating expenses	(6,831)	(5,963)	(6,581)
Operating profit	5,198	3,608	6,563
Income from associates ⁴⁸	892	667	631
Profit before tax	6,090	4,275	7,194

**Strong balance sheet growth with
21%
rise in lending to US\$239bn
Significant-pre-tax profit
contribution from
emerging markets at
67%
First international bank to
complete renminbi trade
settlements across six continents**

Strategic direction

CMB's core strategy is focused on two key initiatives:

to be the leading international business bank in all our markets, leveraging HSBC's extensive geographical network together with its product expertise in payments, trade, receivables finance and

foreign exchange to actively support customers who are trading and investing internationally; and

to be the best bank for small- and medium-sized enterprises in our largest markets.

For footnotes, see page 83.

Review of performance

In 2010, CMB reported profit before tax of US\$6.1bn, 42% higher than in 2009 with growth across all regions. Excluding the gains from the sales in 2010 of HSBC Insurance Brokers and our stake in the Wells Fargo HSBC Trade Bank, and similar non-recurring items in 2009, (see page 14), profit before tax increased by 48%. The rise in profit reflected an improvement in the credit environment and strong growth in world trade.

Revenue grew by 8% to US\$13.7bn, mainly in Asia, where we expanded customer lending significantly and increased our fee income from remittances, trade and investments. Our insurance operations also performed strongly in Asia, with an increased uptake of our life insurance products in Hong Kong. In North America, repricing initiatives led to a notable increase in revenue.

Loan impairment charges and other credit risk provisions declined by 46% to US\$1.8bn with favourable variances in all regions as the credit environment improved and our exposure to higher risk portfolios was managed down.

Excluding CMB's share of the non-recurring accounting gains related to the change in the UK pension scheme, (see page 26), operating expenses increased by 11% to US\$6.8bn as we continued to invest for future revenue growth in those markets that we see as central to international connectivity. We hired more relationship managers in France, Brazil, Mexico and Hong Kong, and continued to invest in systems to improve our customer experience. As a result, our cost efficiency ratio rose to 49.8% in 2010.

CMB's share of income from associates grew by 33% to US\$892m, notably in mainland China.

Customer lending balances rose by 21% to US\$239bn, driven by increased demand in Asia as market sentiment improved, and growth in key developed markets such as France and the UK, where we actively supported corporates and SMEs in response to changes in the economy. Our corporate segment increased lending by 25% to US\$183bn, notably in Hong Kong and mainland China.

CMB attracted over half a million new customers in 2010, taking the total to 3.6m, and we grew customer account balances by 8%, with significant growth in Asia where HSBC was

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)

ranked as the best cash management bank in 2010 by *Euromoney*.

In line with our strategy to be the leading international business bank, we continued to pursue opportunities to expand our customer base of businesses that trade and invest internationally. In 2010, we opened CMB's first corporate branch in Switzerland to enable our Swiss-based customers to access our international banking services, particularly in faster growing markets. In the UK, we recruited 139 new International Commercial Managers to support the international expansion plans of UK businesses.

Our geographical presence across both developed and emerging markets allowed us to capitalise on the rising levels of international trade flows, notably in Asia and Europe, where we gained export market share in 2010. In the Middle East, we increased our lending to exporters in the region by 69%. In the United Arab Emirates (UAE) specifically, our average lending to exporters more than doubled in 2010 to US\$700m.

The number of successful cross-border referrals increased by 77% compared with 2009, with a total transaction value in 2010 of almost US\$15bn. Significantly, successful intra-Asia referrals doubled from 2009, while referrals from mainland China more than doubled reflecting the increased appetite of Chinese business to explore international opportunities.

CMB continued to demonstrate connectivity with other customer groups within HSBC. Our partnership with GB&M allowed us to support our customers in accessing capital markets to help them grow and expand internationally. Successful referrals from CMB represented 51% of total net new money generated from internal referrals to GPB in 2010, while 5% of new Premier accounts were referred from CMB.

CMB has a diverse suite of products to support businesses that trade internationally. We are the second largest export factor globally and, in 2010, we launched our Receivables Finance proposition in Germany, Europe's largest economy, which has rapidly growing export ties with Asia. In the UK, we increased international trade finance by 13%. In addition, we successfully piloted the Supplier Invoice Finance Scheme, a reverse factoring product, in India, mainland China and Hong Kong.

We became the first international bank to provide renminbi-denominated trade settlements across six continents in 2010 and we are one of the largest international banks in Hong Kong to offer renminbi products, with total transactions exceeding US\$6.7bn in 2010.

Our Business Banking propositions are focused on better serving SMEs, especially those that trade internationally. At the end of 2010, we had over 3.4m customers worldwide in the Business Banking segment, representing 55% of CMB's total deposit balances and providing an important source of funding for our Corporate segment.

We continue to recognise the importance of SMEs to sustained economic recovery and provided working capital finance for this sector throughout 2010. In Hong Kong, we maintained our active participation in the Government Special Loan Guarantee Scheme, through which we provided US\$1.5bn in SME financing in 2010. In the UK, we

increased new lending to SMEs by 19% in 2010, opened accounts for over 125,000 customers starting new businesses and added over 170 extra local business managers.

We continued to develop and improve our direct channels through enhanced telephone-based relationship management services in key markets, including the launch of smartphone services in Hong Kong. In the UK, we also launched straight-through foreign exchange services. Notably, we are now the leading direct bank in Europe with over one million SME business customers using our Business Internet Banking platform.

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)**Global Banking and Markets**

GB&M is a global business which provides tailored financial solutions to major government, corporate and institutional clients worldwide.

	2010 US\$m	2009 US\$m	2008 US\$m
Net interest income	7,348	8,610	8,541
Net fee income	4,725	4,363	4,291
Net trading income ⁴⁹	5,831	6,875	481
Other income	2,043	1,972	205
Net operating income⁴⁶	19,947	21,820	13,518
Impairment charges ⁴⁷	(990)	(3,168)	(1,471)
Net operating income	18,957	18,652	12,047
Total operating expenses	(9,962)	(8,537)	(9,092)
Operating profit	8,995	10,115	2,955
Income from associates ⁴⁸	541	366	528
Profit before tax	9,536	10,481	3,483

**Employee expenses (including
payroll and bonus taxes)
in operating expenses
US\$4,737m**

(2009: US\$4,335m; 2008: US\$4,263m)

**Strong contribution from
emerging markets**

**Best Global Emerging
Markets Bank**

**Best Global Emerging
Markets Debt House**

**Emerging Markets
Bond House of the Year**

**Best Debt House
in Asia**

*International Financing
Review Awards 2010*

*Euromoney Awards
for Excellence 2010*

Strategic direction

In 2010, GB&M continued to pursue its now well-established emerging markets-led and financing-focused strategy, encompassing HSBC's objective to be a leading wholesale bank by:

- utilising the Group's extensive distribution network;
- developing GB&M's hub-and-spoke business model; and
- continuing to build capabilities in major hubs to support the delivery of an advanced suite of services to major government, corporate and institutional clients across the HSBC network.

This combination of product depth and distribution strength is fundamental to meeting the needs of existing and new clients and allowing GB&M to achieve its strategic goals.

For footnotes, see page 83.

Review of performance

GB&M reported profit before tax of US\$9.5bn, 9% lower than in 2009. On an underlying basis, which excludes the gains resulting from the sale of Eversholt Rail Group and HSBC Private Equity (Asia) Ltd in 2010, profit before tax declined by 14%, driven by lower income from Balance Sheet Management and Credit and Rates trading and higher operating costs. Profitability benefited from a significant reduction in loan impairment charges and other credit risk provisions. Operating results remained well diversified across our businesses with a strong contribution from emerging markets, where we continued to support existing and anticipated new business, including introducing a China desk in the Middle East and a Latam desk in Hong Kong.

Net operating income before loan impairment charges and other credit risk provisions decreased by 11%, mainly due to lower net interest income in Balance Sheet Management from the maturing of higher yielding positions, low interest rates and flattening yield curves. Lower trading income largely reflected uncertainty in the eurozone, particularly in the second half of 2010. This was offset in part by a net release of US\$429m largely relating to legacy positions in Credit trading and monoline Credit exposures, compared with a reported write-down of US\$331m in 2009, following a general improvement in ABS prices. Trading income also benefited from a small favourable fair value movement on structured liabilities, compared with an adverse fair value movement in 2009, resulting in a reported favourable movement of US\$466m.

Loan impairment charges and other credit risk provisions decreased by US\$2.2bn. A US\$1.2bn reduction in loan impairment charges to US\$500m was driven by a general improvement in the credit environment and the non-recurrence of significant charges taken in relation to a small number of clients in 2009. Credit risk provisions on the available-for-sale portfolio decreased by US\$981m to US\$490m, of which US\$444m related to ABSs, significantly lower than the US\$1.5bn impairment reported in 2009, due to a slowing in the rate of anticipated losses in the underlying collateral pools.

Higher operating expenses in 2010 reflected the one-off payroll and bonus taxes in the UK and France on certain bonuses paid in respect of 2009 totalling US\$309m, the non-recurrence of an accounting gain related to a change in the

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)*Management view of total operating income*

	2010	2009	2008
	US\$m	US\$m	US\$m
Global Markets ⁵⁰	9,173	10,364	2,676
Credit	1,649	2,330	(5,502)
Rates	2,052	2,648	2,033
Foreign Exchange	2,752	2,979	3,842
Equities	755	641	(64)
Securities Services ⁵¹	1,511	1,420	2,116
Asset and Structured Finance	454	346	251
Global Banking	4,621	4,630	5,718
Financing and Equity Capital Markets	2,852	3,070	3,572
Payments and Cash Management ⁵²	1,133	1,053	1,665
Other transaction services ⁵³	636	507	481
Balance Sheet Management ⁵⁴	4,102	5,390	3,618
Global Asset Management	1,077	939	934
Principal Investments	319	42	(415)
Other ⁵⁵	655	455	987
Total operating income	19,947	21,820	13,518

Comparative information has been adjusted to reflect the current management view.

For footnotes, see page 83.

delivery of certain staff benefits in the main UK pension scheme in 2009, higher support costs and continued investment in strategic initiatives being undertaken to drive future revenue growth. These included the development of Prime Services and equity market capabilities and the expansion of the Rates and Foreign Exchange e-commerce platforms. The percentage of total reported compensation pool allocated in respect of performance in 2010 to revenues net of loan impairment charges (excluding payroll taxes levied on 2009 bonuses) remained consistent with 2009 on a reported basis.

Global Markets revenues were second only to the results recorded in 2009, demonstrating the continuing strength of our client-facing businesses. Trading income declined, driven by increased competition and reduced margins across core products. Credit and Rates were adversely affected by less favourable market conditions as European sovereign debt concerns resulted in increased economic uncertainty in the eurozone. Foreign Exchange revenues were lower, reflecting spread compression in the more competitive trading environment and a decline in market volatility. Investment in the Equities business, particularly the enhancement

of the sales and trading platforms, led to increased market share in our target markets despite lower market volumes and increased competition. Securities Services income grew by 4%, with particularly strong performances in Asia driven by increasing market values and Latin America due to higher interest income. Asset and Structured Finance reported higher revenues from increased deal activity during the year.

Global Banking produced a robust performance as it continued the strategy of focusing on key client relationships to drive market share growth in event-driven and other ancillary businesses. A decrease in revenues from Financing and Equity Capital Markets was due to the adverse effect of continued spread compression. Higher project and export finance revenues were driven by increased deal volumes, while growth in revenue and market share was achieved in the advisory business. Equity Capital Markets revenues fell as total deal values declined due to a reduction in client activity. Despite the adverse effect of the continued low interest rate environment, Payments and Cash Management delivered a 6% increase in revenue driven by strong growth in transaction-driven fee income and customer account balances in Asia.

Revenues in Balance Sheet Management remained high by historical standards but, as expected, declined in 2010 as higher-yielding positions matured and the opportunity for reinvestment was limited by the prevailing low interest rate environment and flatter yield curves.

Robust revenue growth was reported in Global Asset Management. Higher management fee income was recorded across all regions, most notably in our emerging markets businesses. Funds under management (FuM) reached a year-end high of US\$439bn at 31 December 2010 of which emerging markets FuM, in countries outside North America, Western Europe, Japan and Australia, were US\$145bn. Total FuM grew by 4% compared with 2009, benefiting from positive net inflows of US\$16bn and strengthening market performance. New funds launched in the year included the Global High Income Fund and the MultiAlpha Global High Yield Bond Fund.

Principal Investments reported an increase in revenues as improved market conditions resulted in higher gains on sale and a reduction in impairments.

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)**Global Private Banking**

GPB works with our high net worth clients to offer both traditional and innovative ways to manage and preserve wealth while optimising returns.

	2010 US\$m	2009 US\$m	2008 US\$m
Net interest income	1,345	1,474	1,612
Net fee income	1,299	1,236	1,476
Other income	449	402	543
Net operating income ⁴⁶	3,093	3,112	3,631
Impairment (charges)/ recoveries ⁴⁷	12	(128)	(68)
Net operating income	3,105	2,984	3,563
Total operating expenses	(2,035)	(1,884)	(2,116)
Operating profit	1,070	1,100	1,447
Income from associates ⁴⁸	(16)	8	
Profit before tax	1,054	1,108	1,447

Client assets over 6% up at

US\$390bn

2009: US\$367bn; 2008: US\$352bn

**Higher investment in GPB
operations in Asia,
Latin America and the Middle East
Best Global Wealth Manager
Euromoney Awards for Excellence 2010**

**Best Private Bank in
Asia**
*Euromoney 2011 Private
Banking Survey*

**Outstanding Private
Bank Middle East**
Private Banker International

Awards 2010

Strategic direction

GPB strives to be the world's leading international private bank, recognised for excellent client experience and global connections.

Our brand, capital strength, extensive global network and positioning provide a strong foundation from which GPB continues to attract and retain clients. Product and service leadership in areas such as alternative investments, foreign exchange, estate planning, credit and investment advice helps us meet the complex international financial needs of individuals and families.

We are well-positioned for sustainable long-term growth through continuing investment in our people, integrated IT solutions and emerging markets-focused domestic operations, along with ensuring our cross-border business meets high standards in the evolving regulatory environment.

For footnotes, see page 83.

Review of performance

Reported profit before tax was US\$1.1bn, 5% below 2009 on a reported and an underlying basis, driven by lower net interest income as the persistent low interest rate environment continued to affect deposit spreads and higher operating expenses. Loan impairment charges fell following the non-recurrence of a single specific impairment charge in North America in 2009 and the release of several charges made in previous years as markets recovered.

Net fee income and trading income rose, notably in Asia, as improved client risk appetite led to higher levels of activity, an increase in transaction volumes and positive net inflows of client assets.

Operating expenses increased, reflecting the hiring of front-line staff to cover emerging markets as part of a long-term strategy to further strengthen our international network to better serve clients, along with investment in systems and higher compliance costs resulting from the evolving regulatory environment.

Client assets

	2010 US\$bn	2009 US\$bn
At 1 January	367	352
Net new money	13	(7)
Value change	13	27
Exchange and other	(3)	(5)
At 31 December	390	367

Reported client assets, which include funds under management and cash deposits, increased by US\$23bn due to net new money inflows compared with outflows in 2009, and favourable market movements. Net inflows benefited from our strength in emerging markets, newly recruited key relationship managers, and cross-business referrals which generated US\$8bn in 2010. This also resulted in an increase in total client assets, the equivalent to many industry definitions of assets under management which includes some non-financial assets held in client trusts, from US\$460bn to US\$499bn. Investor demand for alternatives, including real estate investments, also attracted strong inflows into HSBC Alternative Investments Limited.

The Family Office Partnership had a number of successes in its first full year, producing a complete range of corporate and personal solutions for top tier clients and strengthening its links with GB&M.

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)**Other**

Other contains the results of certain property transactions, unallocated investment activities, centrally held investment companies, movements in fair value of own debt, HSBC's holding company and financing operations.

	2010 US\$m	2009 US\$m	2008 US\$m
Net interest expense	(998)	(1,035)	(956)
Net trading income/ (expense)	(311)	279	(530)
Net income/(expense) from financial instruments designated at fair value	(216)	(6,443)	7,426
Other income	6,185	5,176	6,355
Net operating income/ (expense)⁴⁶	4,660	(2,023)	12,295
Impairment (charges)/ recoveries ⁴⁷	3	(8)	(5)
Net operating income/ (expense)	4,663	(2,031)	12,290
Total operating expenses	(5,918)	(4,715)	(4,174)
Operating profit/(loss)	(1,255)	(6,746)	8,116
Income from associates ⁴⁸	94	26	41
Profit/(loss) before tax	(1,161)	(6,720)	8,157

US\$250m

**gain on sale and leaseback of Paris
and New York headquarters buildings**
US\$6.5bn

**reduction in adverse fair value
movements on own debt**
**Investment in
Group Service Centres**
as migrated activities increase

For footnotes, see page 83.

Notes

Reported loss before tax of US\$1.2bn compared with a loss before tax of US\$6.7bn in 2009. This included adverse movements of US\$63m on the fair value of our own debt attributable to movements in credit spreads in 2010, compared with adverse movements of US\$6.5bn in 2009. In addition, 2010 included gains of US\$188m following the dilution of our holding in Ping An Insurance and US\$62m on the reclassification of Bao Viet to an associate following the purchase of an additional 8% stake. On an underlying basis, the loss before tax increased by US\$1.2bn to US\$1.3bn. The main items reported under 'Other', are described in footnote 44 on page 85. Net trading expense of US\$311m compared with income of US\$276m in 2009. This change was largely attributable to fair value movements on cross-currency swaps used to economically hedge fixed rate long-term debt issued by HSBC Holdings. The adverse fair value movements of US\$304m, which were driven by a decline in long-term US interest rates relative to sterling and euro rates, compared with favourable fair value movements of US\$748m on these instruments in 2009. This was partly offset by the non-recurrence of fair value losses arising from the implied contingent forward contract entered into with the underwriters of our rights issue in 2009 and forward foreign exchange contracts associated with the rights issue, which were accounted as derivatives with fair value taken to profit or loss in 2009.

We recognised gains of US\$194m and US\$56m, respectively, from the sale and leaseback of our headquarters buildings in Paris and New York. These compared with more substantial underlying gains totalling US\$667m (US\$686m as reported) on the sale and leaseback of 8 Canada Square, London and the sale of a property in Hong Kong in 2009.

Operating expenses rose by 24% to US\$5.9bn as an increasing number of operational activities were centralised, notably in the US. These costs were previously incurred directly by customer groups, but are now recorded in 'Other' and charged to customer groups through a recharge mechanism with income reported as 'Other operating income'. In addition, costs at our Group Service Centres rose by 6% as the number of migrated activities increased in line with our Global Resourcing model.

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Report of the Directors: Operating and Financial Review (continued)**Reconciliation of reported and underlying profit/(loss) before tax****Personal Financial Services***2010 compared with 2009*

	2009 as reported US\$m	2009 adjust- ments US\$m	Currency translation ¹¹ US\$m	2009 at 2010 exchange rates ¹² US\$m	2010 as reported US\$m	2010 adjust- ments ¹⁰ US\$m	2010 under- lying US\$m	Re- ported change ¹³ %	Under- lying change ¹³ %
Net interest income	25,107		419	25,526	24,161	(8)	24,153	(4)	(5)
Net fee income	8,238	(8)	115	8,345	7,336	(1)	7,335	(11)	(12)
Other income	2,070		101	2,171	1,079	(5)	1,074	(48)	(51)
Net operating income¹⁵	35,415	(8)	635	36,042	32,576	(14)	32,562	(8)	(10)
Loan impairment charges and other credit risk provisions	(19,902)		(271)	(20,173)	(11,259)		(11,259)	43	44
Net operating income	15,513	(8)	364	15,869	21,317	(14)	21,303	37	34
Operating expenses	(18,292)	6	(440)	(18,726)	(18,805)	4	(18,801)	(3)	
Operating profit/(loss)	(2,779)	(2)	(76)	(2,857)	2,512	(10)	2,502		
Income from associates	714		6	720	1,006		1,006	41	40
Profit/(loss) before tax	(2,065)	(2)	(70)	(2,137)	3,518	(10)	3,508		

2009 compared with 2008

2008

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	2008 as reported US\$m	2008 adjust- ments ¹⁰ US\$m	Currency translation ¹¹ US\$m	at 2009 exchange rates ¹⁶ US\$m	2009 as reported US\$m	2009 adjust- ments ¹⁰ US\$m	2009 under- lying US\$m	Re- ported change ¹³ %	Under- lying change ¹³ %
Net interest income	29,419	(36)	(1,534)	27,849	25,107	(3)	25,104	(15)	(10)
Net fee income	10,107	(32)	(645)	9,430	8,238		8,238	(18)	(13)
Other income	1,963	(121)	(258)	1,584	2,070	(1)	2,069	5	31
Net operating income ¹⁵	41,489	(189)	(2,437)	38,863	35,415	(4)	35,411	(15)	(9)
Loan impairment charges and other credit risk provisions	(21,220)	3	595	(20,622)	(19,902)		(19,902)	6	3
Net operating income	20,269	(186)	(1,842)	18,241	15,513	(4)	15,509	(23)	(15)
Operating expenses (excluding goodwill impairment)	(21,140)	38	1,372	(19,730)	(18,292)	1	(18,291)	13	7
Goodwill impairment	(10,564)			(10,564)				100	100
Operating loss	(11,435)	(148)	(470)	(12,053)	(2,779)	(3)	(2,782)	76	77
Income from associates	461		13	474	714		714	55	51
Loss before tax	(10,974)	(148)	(457)	(11,579)	(2,065)	(3)	(2,068)	81	82

For footnotes, see page 83.

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)**Commercial Banking***2010 compared with 2009*

	2009 as reported US\$m	2009 adjust- ments ¹⁰ US\$m	Currency translation ¹¹ US\$m	2009 at 2010 exchange rates ¹² US\$m	2010 as reported US\$m	2010 adjust- ments ¹⁰ US\$m	2010 under- lying US\$m	Re- ported change ¹³ %	Under- lying change ¹³ %
Net interest income	7,883	(1)	193	8,075	8,487	(20)	8,467	8	5
Net fee income	3,702	(164)	51	3,589	3,964	(2)	3,962	7	10
Other income	1,268	(283)	12	997	1,383	(124)	1,259	9	26
Net operating income¹⁵	12,853	(448)	256	12,661	13,834	(146)	13,688	8	8
Loan impairment charges and other credit risk provisions	(3,282)		(73)	(3,355)	(1,805)		(1,805)	45	46
Net operating income	9,571	(448)	183	9,306	12,029	(146)	11,883	26	28
Operating expenses	(5,963)	143	(122)	(5,942)	(6,831)	13	(6,818)	(15)	(15)
Operating profit	3,608	(305)	61	3,364	5,198	(133)	5,065	44	51
Income from associates	667	(1)	3	669	892		892	34	33
Profit before tax	4,275	(306)	64	4,033	6,090	(133)	5,957	42	48

2009 compared with 2008

	2008 as reported US\$m	2008 adjust- ments ¹⁰ US\$m	Currency translation ¹¹ US\$m	2008 at 2009 exchange rates ¹⁶ US\$m	2009 as reported US\$m	2009 adjust- ments ¹⁰ US\$m	2009 under- lying US\$m	Re- ported change ¹³ %	Under- lying change ¹³ %
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Net interest income	9,494	(29)	(697)	8,768	7,883	(45)	7,838	(17)	(11)
Net fee income	4,097	(26)	(367)	3,704	3,702	(5)	3,697	(10)	
Other income	1,726	(464)	(213)	1,049	1,268	(295)	973	(27)	(7)
Net operating income ¹⁵	15,317	(519)	(1,277)	13,521	12,853	(345)	12,508	(16)	(7)
Loan impairment charges and other credit risk provisions	(2,173)	3	68	(2,102)	(3,282)		(3,282)	(51)	(56)
Net operating income	13,144	(516)	(1,209)	11,419	9,571	(345)	9,226	(27)	(19)
Operating expenses	(6,581)	30	537	(6,014)	(5,963)	27	(5,936)	9	1
Operating profit	6,563	(486)	(672)	5,405	3,608	(318)	3,290	(45)	(39)
Income from associates	631		7	638	667		667	6	5
Profit before tax	7,194	(486)	(665)	6,043	4,275	(318)	3,957	(41)	(35)

For footnotes, see page 83.

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)**Global Banking and Markets***2010 compared with 2009*

	2009 as reported US\$m	2009 adjust- ment ¹⁰ US\$m	Currency translation ¹¹ US\$m	2009 at 2010 exchange rates ¹² US\$m	2010 as reported US\$m	2010 adjust- ments ¹⁰ US\$m	2010 under- lying US\$m	Re- ported change ¹³ %	Under- lying change ¹³ %
Net interest income	8,610		60	8,670	7,348	(3)	7,345	(15)	(15)
Net fee income	4,363	(38)	20	4,345	4,725		4,725	8	9
Net trading income	6,875		103	6,978	5,831		5,831	(15)	(16)
Other income	1,972			1,972	2,043	(341)	1,702	4	(14)
Net operating income¹⁵	21,820	(38)	183	21,965	19,947	(344)	19,603	(9)	(11)
Loan impairment charges and other credit risk provisions	(3,168)		13	(3,155)	(990)		(990)	69	69
Net operating income	18,652	(38)	196	18,810	18,957	(344)	18,613	2	(1)
Operating expenses	(8,537)	51	(25)	(8,511)	(9,962)	2	(9,960)	(17)	(17)
Operating profit	10,115	13	171	10,299	8,995	(342)	8,653	(11)	(16)
Income from associates	366		2	368	541		541	48	47
Profit before tax	10,481	13	173	10,667	9,536	(342)	9,194	(9)	(14)

2009 compared with 2008

	2008 as reported US\$m	2008 adjust- ment ¹⁰ US\$m	Currency translation ¹¹ US\$m	2008 at 2009 exchange rates ¹⁶ US\$m	2009 as reported US\$m	2009 adjust- ments ¹⁰ US\$m	2009 under- lying US\$m	Re- ported change ¹³ %	Under- lying change ¹³ %
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Net interest income	8,541	(451)	8,090	8,610	(5)	8,605	1	6
Net fee income	4,291	(267)	4,024	4,363	(1)	4,362	2	8
Net trading income	481	(404)	77	6,875		6,875	1,329	8,829
Other income	205	(151)	54	1,972	(2)	1,970	862	3,548
Net operating income ¹⁵	13,518	(1,273)	12,245	21,820	(8)	21,812	61	78
Loan impairment charges and other credit risk provisions	(1,471)	45	(1,426)	(3,168)		(3,168)	(115)	(122)
Net operating income	12,047	(1,228)	10,819	18,652	(8)	18,644	55	72
Operating expenses	(9,092)	743	(8,349)	(8,537)	3	(8,534)	6	(2)
Operating profit	2,955	(485)	2,470	10,115	(5)	10,110	242	309
Income from associates	528	6	534	366		366	(31)	(31)
Profit before tax	3,483	(479)	3,004	10,481	(5)	10,476	201	249

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)*Balance sheet data significant to Global Banking and Markets*

	Europe US\$m	Hong Kong US\$m	Rest of Asia- Pacific US\$m	Middle East US\$m	North America US\$m	Latin America US\$m	Total US\$m
At 31 December 2010							
Trading assets ⁷¹	232,918	32,023	18,256	958	87,120	6,459	377,734
Derivative assets ⁷²	199,654	21,644	17,135	832	65,153	3,955	308,373
Trading liabilities	178,861	8,650	3,846	122	91,980	2,702	286,161
Derivative liabilities ⁷²	199,751	22,622	17,121	845	66,323	3,913	310,575
At 31 December 2009							
Trading assets ⁷¹	294,951	25,742	15,960	511	67,466	6,283	410,913
Derivative assets ⁷²	190,900	16,937	15,660	668	61,192	2,820	288,177
Trading liabilities	169,814	10,720	3,040	13	69,302	2,875	255,764
Derivative liabilities ⁷²	191,480	16,619	15,500	651	60,178	3,270	287,698
At 31 December 2008							
Trading assets ⁷¹	281,089	45,398	19,192	414	74,498	5,004	425,595
Derivative assets ⁷²	349,035	34,146	29,124	1,014	156,056	9,618	578,993
Trading liabilities	144,759	13,056	3,633	54	72,325	2,546	236,373
Derivative liabilities ⁷²	345,970	35,693	29,097	1,016	152,907	9,088	573,771

For footnotes, see page 83.

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)**Global Private Banking***2010 compared with 2009*

	2009 as reported US\$m	2009 adjust- ments ¹⁰ US\$m	Currency translation ¹¹ US\$m	2009 at 2010 exchange rates ¹² US\$m	2010 as reported US\$m	2010 adjust- ments ¹⁰ US\$m	2010 under- lying US\$m	Re- ported change ¹³ %	Under- lying change ¹³ %
Net interest income	1,474		(2)	1,472	1,345		1,345	(9)	(9)
Net fee income	1,236		(1)	1,235	1,299		1,299	5	5
Other income	402			402	449	1	450	12	12
Net operating income¹⁵	3,112		(3)	3,109	3,093	1	3,094	(1)	
Loan impairment charges and other credit risk provisions	(128)		1	(127)	12		12		
Net operating income	2,984		(2)	2,982	3,105	1	3,106	4	4
Operating expenses	(1,884)		3	(1,881)	(2,035)		(2,035)	(8)	(8)
Operating profit	1,100		1	1,101	1,070	1	1,071	(3)	(3)
Income from associates	8			8	(16)		(16)		
Profit before tax	1,108		1	1,109	1,054	1	1,055	(5)	(5)

2009 compared with 2008

	2008 as reported US\$m	2008 adjust- ments ¹⁰ US\$m	Currency translation ¹¹ US\$m	2008 at 2009 exchange rates ¹⁶ US\$m	2009 as reported US\$m	2009 adjust- ments ¹⁰ US\$m	2009 under- lying US\$m	Re- ported change ¹³ %	Under- lying change ¹³ %
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Net interest income	1,612	(52)	1,560	1,474	1,474	(9)	(6)
Net fee income	1,476	(33)	1,443	1,236	1,236	(16)	(14)
Other income	543	(19)	524	402	402	(26)	(23)
Net operating income ¹⁵	3,631	(104)	3,527	3,112	3,112	(14)	(12)
Loan impairment charges and other credit risk provisions	(68)	2	(66)	(128)	(128)	(88)	(94)
Net operating income	3,563	(102)	3,461	2,984	2,984	(16)	(14)
Operating expenses	(2,116)	54	(2,062)	(1,884)	(1,884)	11	9
Operating profit	1,447	(48)	1,399	1,100	1,100	(24)	(21)
Income from associates				8	8		
Profit before tax	1,447	(48)	1,399	1,108	1,108	(23)	(21)

For footnotes, see page 83.

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)**Other***2010 compared with 2009*

	2009 as reported US\$m	2009 adjust- ments ¹¹ US\$m	Currency translation ¹¹ US\$m	2009 at 2010 exchange rates ¹² US\$m	2010 as reported US\$m	2010 adjust- ments ¹⁰ US\$m	2010 under- lying US\$m	Re- ported change ¹³ %	Under- lying change ¹³ %
Net interest expense	(1,035)		21	(1,014)	(998)		(998)	4	2
Net fee income	125		(3)	122	31		31	(75)	(75)
Changes in fair value ¹⁴	(6,533)	6,533			(63)	63		99	
Other income	5,420		29	5,449	5,690	(250)	5,440	5	
Net operating income/(expense)¹⁵	(2,023)	6,533	47	4,557	4,660	(187)	4,473		(2)
Loan impairment (charges)/recoveries and other credit risk provisions	(8)			(8)	3		3		
Net operating income/(expense)	(2,031)	6,533	47	4,549	4,663	(187)	4,476		(2)
Operating expenses	(4,715)		(50)	(4,765)	(5,918)		(5,918)	(26)	(24)
Operating loss	(6,746)	6,533	(3)	(216)	(1,255)	(187)	(1,442)	81	(568)
Income from associates	26			26	94		94	262	262
Loss before tax	(6,720)	6,533	(3)	(190)	(1,161)	(187)	(1,348)	83	(609)

2009 compared with 2008

	2008 as reported	2008 adjust- ments	Currency translation	2008 at 2009 exchange rates	2009 as reported	2009 adjust- ments	2009 under- lying	Re- ported	Under- lying
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	reported US\$m	ments ¹⁰ US\$m	translation ¹¹ US\$m	rates ¹⁶ US\$m	reported US\$m	ments ¹⁰ US\$m	lying US\$m	change ¹³ %	change ¹³ %
Net interest expense	(956)		12	(944)	(1,035)		(1,035)	(8)	(10)
Net fee income	53		(3)	50	125		125	136	150
Changes in fair value ¹⁴	6,570	(6,570)			(6,533)	6,533			
Gains on disposal of French regional banks	2,445	(2,445)						(100)	
Other income	4,183	(95)	(13)	4,075	5,420		5,420	30	33
Net operating income/(expense) ¹⁵	12,295	(9,110)	(4)	3,181	(2,023)	6,533	4,510		42
Loan impairment charges and other credit risk provisions	(5)		(1)	(6)	(8)		(8)	(60)	(33)
Net operating income/(expense)	12,290	(9,110)	(5)	3,175	(2,031)	6,533	4,502		42
Operating expenses	(4,174)		70	(4,104)	(4,715)		(4,715)	(13)	(15)
Operating profit/(loss)	8,116	(9,110)	65	(929)	(6,746)	6,533	(213)		77
Income from associates	41		(1)	40	26		26	(37)	(35)
Profit/(loss) before tax	8,157	(9,110)	64	(889)	(6,720)	6,533	(187)		79

For footnotes, see page 83.

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)**Analysis by customer group and global business***HSBC profit/(loss) before tax and balance sheet data*

	Personal		Global	2010		Inter-	
	Financial	Commercial	Banking	Global	Other	segment	Total
	Services	Banking	&	Private	44	56	
	US\$m	US\$m	Markets	Banking	US\$m	US\$m	US\$m
			US\$m	US\$m			
<i>Profit/(loss) before tax</i>							
Net interest income/(expense)	24,161	8,487	7,348	1,345	(998)	(902)	39,441
Net fee income	7,336	3,964	4,725	1,299	31		17,355
Trading income/(expense) excluding net interest income	(107)	427	4,327	391	(358)		4,680
Net interest income on trading activities	28	28	1,504	21	47	902	2,530
Net trading income/(expense) ⁴⁹	(79)	455	5,831	412	(311)	902	7,210
Changes in fair value of long- term debt issued and related derivatives					(258)		(258)
Net income from other financial instruments designated at fair value	1,210	190	36		42		1,478
Net income/(expense) from financial instruments designated at fair value	1,210	190	36		(216)		1,220

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Gains less losses from financial investments	42	(1)	797	(6)	136		968
Dividend income	27	12	48	5	20		112
Net earned insurance premiums	9,737	1,379	41		(11)		11,146
Other operating income	650	585	1,147	38	6,005	(5,863)	2,562
Total operating income	43,084	15,071	19,973	3,093	4,656	(5,863)	80,014
Net insurance claims ⁵⁷	(10,508)	(1,237)	(26)		4		(11,767)
Net operating income⁴⁶	32,576	13,834	19,947	3,093	4,660	(5,863)	68,247
Loan impairment (charges)/recoveries and other credit risk provisions	(11,259)	(1,805)	(990)	12	3		(14,039)
Net operating income	21,317	12,029	18,957	3,105	4,663	(5,863)	54,208
Employee expenses ⁵⁸	(5,388)	(2,153)	(4,735)	(1,237)	(6,323)		(19,836)
Other operating expenses	(13,417)	(4,678)	(5,227)	(798)	405	5,863	(17,852)
Total operating expenses	(18,805)	(6,831)	(9,962)	(2,035)	(5,918)	5,863	(37,688)
Operating profit/(loss)	2,512	5,198	8,995	1,070	(1,255)		16,520
Share of profit/(loss) in associates and joint ventures	1,006	892	541	(16)	94		2,517
Profit/(loss) before tax	3,518	6,090	9,536	1,054	(1,161)		19,037
	%	%	%	%	%		%
Share of HSBC's profit before tax	18.5	32.0	50.1	5.5	(6.1)		100.0
Cost efficiency ratio	57.7	49.4	49.9	65.8	127.0		55.2
<i>Balance sheet data⁴⁵</i>							
	US\$m	US\$m	US\$m	US\$m	US\$m		US\$m
Loans and advances to customers (net)	390,957	239,286	284,503	40,665	2,955		958,366
Total assets	527,698	296,797	1,758,315	116,846	161,458	(406,425)	2,454,689

Customer accounts	525,184	286,007	308,453	107,130	951	1,227,725
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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)

	Personal Financial Services US\$m	Commercial Banking US\$m	Global Banking & Markets US\$m	2009 Global Private Banking US\$m	Other ⁴⁴ US\$m	Inter- segment elimination ⁵⁶ US\$m	Total US\$m
<i>Profit/(loss) before tax</i>							
Net interest income/(expense)	25,107	7,883	8,610	1,474	(1,035)	(1,309)	40,730
Net fee income	8,238	3,702	4,363	1,236	125		17,664
Trading income excluding net interest income	637	332	4,701	322	244		6,236
Net interest income on trading activities	65	22	2,174	22	35	1,309	3,627
Net trading income ⁴⁹	702	354	6,875	344	279	1,309	9,863
Changes in fair value of long- term debt issued and related derivatives Net income/(expense) from other financial instruments designated at fair value	2,339	100	473		(6,247)		(6,247)
Net income/(expense) from financial instruments designated at fair value	2,339	100	473		(6,443)		(3,531)
Gains less losses from financial investments	224	23	265	5	3		520
Dividend income	33	8	68	5	12		126
Net earned insurance premiums	9,534	886	54		(3)		10,471

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Other operating income	809	739	1,146	48	5,042	(4,996)	2,788
Total operating income/(expense)	46,986	13,695	21,854	3,112	(2,020)	(4,996)	78,631
Net insurance claims ⁵⁷	(11,571)	(842)	(34)		(3)		(12,450)
Net operating income/(expense) ⁴⁶	35,415	12,853	21,820	3,112	(2,023)	(4,996)	66,181
Loan impairment charges and other credit risk provisions	(19,902)	(3,282)	(3,168)	(128)	(8)		(26,488)
Net operating income/(expense)	15,513	9,571	18,652	2,984	(2,031)	(4,996)	39,693
Employee expenses ⁵⁸	(6,069)	(2,072)	(4,335)	(1,198)	(4,790)		(18,464)
Other operating expenses	(12,223)	(3,891)	(4,202)	(686)	75	4,996	(15,931)
Total operating expenses	(18,292)	(5,963)	(8,537)	(1,884)	(4,715)	4,996	(34,395)
Operating profit/(loss)	(2,779)	3,608	10,115	1,100	(6,746)		5,298
Share of profit in associates and joint ventures	714	667	366	8	26		1,781
Profit/(loss) before tax	(2,065)	4,275	10,481	1,108	(6,720)		7,079
	%	%	%	%	%		%
Share of HSBC's profit before tax	(29.2)	60.4	148.1	15.6	(94.9)		100.0
Cost efficiency ratio	51.7	46.4	39.1	60.5	(233.1)		52.0
<i>Balance sheet data</i> ⁴⁵							
	US\$m	US\$m	US\$m	US\$m	US\$m		US\$m
Loans and advances to customers (net)	399,460	199,674	256,956	37,031	3,110		896,231
Total assets	554,074	251,143	1,683,672	116,148	150,983	(391,568)	2,364,452
Customer accounts	499,109	267,388	284,727	106,533	1,277		1,159,034

For footnotes, see page 83.

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)*Profit/(loss) before tax and balance sheet data (continued)*

Total	Personal Financial Services US\$m	Commercial Banking US\$m	Global Banking & Markets US\$m	2008 Global Private Banking US\$m	Other ⁴⁴ US\$m	Inter- segment elimination ⁵⁶ US\$m	Total US\$m
<i>Profit/(loss) before tax</i>							
Net interest income/(expense)	29,419	9,494	8,541	1,612	(956)	(5,547)	42,563
Net fee income	10,107	4,097	4,291	1,476	53		20,024
Trading income/(expense) excluding net interest income	175	369	157	408	(262)		847
Net interest income/(expense) on trading activities	79	17	324	14	(268)	5,547	5,713
Net trading income/(expense) ⁴⁹	254	386	481	422	(530)	5,547	6,560
Changes in fair value of long- term debt issued and related derivatives Net income/(expense) from other financial instruments designated at fair value	(2,912)	(224)	(438)		6,679	747	6,679 (2,827)
Net income/(expense) from financial instruments designated at fair value	(2,912) 663	(224) 193	(438) (327)		7,426 (396)		3,852 197

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Gains less losses from financial investments							
Dividend income	90	88	76	8	10		272
Net earned insurance premiums	10,083	679	105		(17)		10,850
Gains on disposal of French regional banks					2,445		2,445
Other operating income	259	939	868	49	4,261	(4,568)	1,808
Total operating income	47,963	15,652	13,597	3,631	12,296	(4,568)	88,571
Net insurance claims ⁵⁷	(6,474)	(335)	(79)		(1)		(6,889)
Net operating income⁴⁶	41,489	15,317	13,518	3,631	12,295	(4,568)	81,682
Loan impairment charges and other credit risk provisions	(21,220)	(2,173)	(1,471)	(68)	(5)		(24,937)
Net operating income	20,269	13,144	12,047	3,563	12,290	(4,568)	56,745
Employee expenses ⁵⁸	(7,905)	(2,549)	(4,263)	(1,308)	(4,767)		(20,792)
Goodwill impairment	(10,564)						(10,564)
Other operating expenses	(13,235)	(4,032)	(4,829)	(808)	593	4,568	(17,743)
Total operating expenses	(31,704)	(6,581)	(9,092)	(2,116)	(4,174)	4,568	(49,099)
Operating profit/(loss)	(11,435)	6,563	2,955	1,447	8,116		7,646
Share of profit in associates and joint ventures	461	631	528		41		1,661
Profit/(loss) before tax	(10,974)	7,194	3,483	1,447	8,157		9,307
	%	%	%	%	%		%
Share of HSBC's profit before tax	(117.9)	77.3	37.4	15.6	87.6		100.0
Cost efficiency ratio	76.4	43.0	67.3	58.3	33.9		60.1
<i>Balance sheet data⁴⁵</i>							
	US\$m	US\$m	US\$m	US\$m	US\$m		US\$m
Loans and advances to customers (net)	401,402	203,949	287,306	37,590	2,621		932,868

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Total assets	527,901	249,218	1,991,852	133,216	145,581	(520,303)	2,527,465
Customer accounts	440,338	235,879	320,386	116,683	2,041		1,115,327

For footnotes, see page 83.

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)**Geographical regions**

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Summary	

Additional information on results in 2010 may be found in the Financial Summary on pages 14 to 36.

In the analysis of profit by geographical regions that follows, operating income and operating expenses include intra-HSBC items of US\$3,125m (2009: US\$2,756m; 2008: US\$2,492m).

Profit/(loss) before tax

	2010		2009		2008	
	US\$m	%	US\$m	%	US\$m	%
Europe	4,302	22.6	4,009	56.7	10,869	116.7
Hong Kong	5,692	29.9	5,029	71.0	5,461	58.7
Rest of Asia-Pacific	5,902	31.0	4,200	59.3	4,722	50.7
Middle East	892	4.7	455	6.4	1,746	18.8
North America	454	2.4	(7,738)	(109.3)	(15,528)	(166.8)
Latin America	1,795	9.4	1,124	15.9	2,037	21.9
	19,037	100.0	7,079	100.0	9,307	100.0

*Total assets*⁴⁵

	At 31 December			
	2010		2009	
	US\$m	%	US\$m	%
Europe	1,249,527	50.9	1,268,600	53.7
Hong Kong	429,565	17.5	399,243	16.9
Rest of Asia-Pacific	278,062	11.3	222,139	9.4
Middle East	52,757	2.1	48,107	2.0
North America	492,487	20.1	475,014	20.1
Latin America	139,938	5.7	115,967	4.9
Intra-HSBC items	(187,647)	(7.6)	(164,618)	(7.0)
	2,454,689	100.0	2,364,452	100.0

*Risk-weighted assets*⁵⁹

	At 31 December			
	2010		2009	
	US\$bn	%	US\$bn	%
Total	1,103.1		1,133.2	
Europe	301.6	27.2	339.7	29.8
Hong Kong	106.9	9.7	119.5	10.5
Rest of Asia-Pacific	217.5	19.6	173.9	15.3
Middle East	54.1	4.9	54.3	4.8
North America	330.7	29.9	369.2	32.4
Latin America	95.9	8.7	81.7	7.2

For footnote, see page 83.

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)**Europe**

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

	2010	2009	2008
	US\$m	US\$m	US\$m
Net interest income	11,250	12,268	9,696
Net fee income	6,371	6,267	7,492
Net trading income	2,863	5,459	5,357
Other income/(expense)	2,266	(450)	8,134
Net operating income⁴⁶	22,750	23,544	30,679
Impairment charges ⁴⁷	(3,020)	(5,568)	(3,754)
Net operating income	19,730	17,976	26,925
Total operating expenses	(15,445)	(13,988)	(16,072)
Operating profit	4,285	3,988	10,853
Income from associates ⁴⁸	17	21	16
Profit before tax	4,302	4,009	10,869
Cost efficiency ratio	67.9%	59.4%	52.4%
Year-end staff numbers	75,698	76,703	82,093

**Reduction in
underlying impairment charges⁴⁷**

45%

**Total UK mortgage
market share**

5.2%

2009: 4.8%

**Strong trade
revenue growth**

For footnotes, see page 83.

The commentary on Europe is on an underlying basis unless stated otherwise.

Economic background

After falling by 4.9% in 2009, **UK** Gross Domestic Product (GDP) only partially recovered in 2010, rising 1.4%. This revival in activity was not reflected in a corresponding rise in employment, and the unemployment rate remained at 7.9% in the three months to November. Despite the general economic weakness, the annual rate of Consumer Price Index (CPI) inflation rose during 2010, reaching 3.7% in December, partly because of the rise in value added tax to 17.5% in January, and increases in the price of food and energy following rapid gains in global commodity prices. Wage growth remained subdued, however, with average earnings rising just 2.0% in the year to December. The Bank of England chose to maintain Bank Rate at 0.5% throughout 2010.

The **eurozone** economy also partially recovered during the year, with GDP rising 1.7% in 2010 compared to 2009. The region benefited from the pick-up in the world economy and some improvement in domestic demand. Within the region, Germany recorded the strongest growth rate with its GDP rising 3.5% in the year as a whole. The unemployment rate in the eurozone increased slightly to 10.0% by the end of 2010. The large increases in government debt that emerged in certain parts of the region in recent years began to put upward pressure on government bond yields during 2010, and some governments encountered funding difficulties. In response, a temporary European support fund, the 440bn European Financial Stability Facility was created, and the EU set aside 60bn in a package named the European Financial Stabilisation Mechanism. Greece received a 110bn aid package provided jointly by the International Monetary Fund and eurozone governments. Ireland also drew on international assistance in December. The European Central Bank left its key interest rate at 1.0% throughout the year.

Review of performance

Our European operations reported a pre-tax profit of US\$4.3bn, compared with US\$4.0bn in 2009, an increase of 7%. In 2010, this included adverse fair value movements of US\$198m due to the change in credit spreads on the Group's own debt held at fair value, compared with adverse fair value movements of US\$2.8bn in 2009. In addition, we made gains of US\$107m on the disposal of the HSBC Insurance Brokers business and US\$255m on the sale of Eversholt Rail Group. In 2009, we recorded a gain on the sale of the residual stake in our UK card merchant acquiring business. Excluding these items, underlying pre-tax profits decreased by 35%,

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)*Profit/(loss) before tax by country within customer groups and global businesses*

	Personal Financial Services US\$m	Commercial Banking US\$m	Global Banking & Markets US\$m	Global Private Banking US\$m	Other US\$m	Total US\$m
2010						
UK	1,223	827	1,730	223	(1,605)	2,398
France ⁶⁰	109	135	405	18	26	693
Germany		32	267	30	4	333
Malta	35	56	19			110
Switzerland		(5)		265		260
Turkey	64	80	105	1		250
Other	(142)	80	200	103	17	258
	1,289	1,205	2,726	640	(1,558)	4,302
2009						
UK	364	1,026	3,045	252	(2,561)	2,126
France ⁶⁰	54	102	894	3	(429)	624
Germany		21	255	32	(18)	290
Malta	33	58	9			100
Switzerland			5	448	(3)	450
Turkey	43	97	119	2		261
Other	(182)	(12)	218	117	17	158
	312	1,292	4,545	854	(2,994)	4,009
2008						
UK	1,546	2,361	(469)	250	2,997	6,685
France ⁶⁰	139	176	273	10	2,242	2,840
Germany		31	184	32	(22)	225
Malta	59	67	16			142
Switzerland				553		553
Turkey	3	91	130			224
Other	(89)	(4)	61	153	79	200

1,658	2,722	195	998	5,296	10,869
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For footnote, see page 83.

largely due to lower income from GB&M, whose exceptional results of 2009 were not repeated, and an unfavourable year on year movement in certain non-qualifying hedges of US\$1.1bn.

GB&M results remained strong by historical standards. However, revenues decreased in 2010 due to less favourable market conditions caused by the impact of the European sovereign debt crisis, particularly in the second half of the year, and lower revenues, as forecast, in Balance Sheet Management.

In PFS, we continued to build long-term relationships through our Premier and Advance offerings, focusing on wealth management and secured lending. We increased our total UK mortgage market share to 5.2%, while maintaining a conservative new lending loan to value ratio of 54%.

In CMB, we made further progress on our strategy of becoming the leading international business bank. We also expanded our business in Germany and launched in Switzerland. In the UK, we increased new lending to SMEs by 19% in 2010.

Net interest income decreased by 7%. Balance Sheet Management revenues declined, as higher-yielding positions matured, interest rates remained low and yield curves flattened in 2010. In Global Banking, tighter spreads in the lending business and lower average lending balances as customers reduced their debt also contributed to the decrease. Customer deposit spreads were adversely affected by the low interest rate environment and competition for deposits. These reductions were offset in part by growth in mortgage lending in the UK and improved asset spreads in both PFS and CMB.

Net fee income increased by 7%, reflecting higher management fees due to an increase in the average value of funds under management, which arose from net inflows and higher market performance. Fees were also received for management services we provided to certain of our Structured Investment Conduits. Partly offsetting these increases were reductions in the levels of debt and equity issuance in the market, compared with the significant volumes seen in 2009.

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)

Net trading income decreased by 47% to US\$2.9bn. Less favourable market conditions caused by the impact of the European sovereign debt crisis adversely affected Credit and Rates income. Spread compression from increased competition similarly affected foreign exchange revenues. In addition, net interest income earned on trading activities decreased, driven by reduced holdings of debt securities. These decreases were offset in part by lower net adverse fair value movements on structured liabilities.

Net trading income also included adverse fair value movements of US\$304m on non-qualifying hedges used to economically hedge fixed-rate long-term debt issued by HSBC Holdings. These movements were driven by the decline in long-term US dollar interest rates relative to sterling and euro rates in 2010, and compared with favourable fair value movements of US\$748m on these instruments in 2009.

Within our legacy Credit book, a net release of previous write-downs on ABSs and monoline exposures as asset prices improved was more than offset by the non-recurrence of gains in other parts of the business.

Net income from financial instruments designated at fair value fell by US\$808m. The growth in equity markets in 2010 was lower than in 2009, resulting in lower investment gains recognised on the fair value of assets held to meet liabilities under insurance and investment contracts. To the extent that these gains accrued to policyholders holding unit-linked insurance policies and insurance or investment contracts with DPF, there was a corresponding decrease in

Net insurance claims incurred and movement in liabilities to policyholders. In addition, adverse foreign exchange movements were reported in the year on foreign currency debt designated at fair value, issued as part of our overall funding strategy with an offset from trading assets held as economic hedges reported in *Net trading income*.

Gains less losses from financial investments increased by US\$455m as improved market conditions led to gains on sale of private equity investments and lower impairment charges on certain available-for-sale investments.

Net earned insurance premiums were in line with 2009. The decision in 2009 to place our UK motor insurance business into run-off resulted in no new premiums being written in 2010. In addition, a decision was taken during 2010 not to renew certain contracts in the Irish business. By contrast, we generated strong sales activity in the UK life and French insurance businesses.

Other operating income decreased by US\$193m because the gain on the sale and leaseback of our Paris headquarters building in 2010 was exceeded by the gain on the sale and leaseback of the Group's London headquarters building in 2009.

Net insurance claims incurred and movement in liabilities to policyholders decreased by 11%. This was driven by lower investment gains compared with 2009 and by the non-recurrence of the strengthening of reserves in 2009 on the now-closed UK motor insurance book which reflected the rising incidence and severity of claims at that time. The decision not to renew certain contracts in the Irish business resulted in a further decrease in claims.

Loan impairment charges and other credit risk provisions decreased by 45% to US\$3.0bn, reflecting the more stable credit environment and helped by mitigating actions taken by management. In GB&M, the improved credit outlook, loan restructuring activity, a release of previous collective impairments and lower specific impairment charges in 2010 contributed to a decline in loan impairment charges and other credit risk provisions. Credit risk provisions on certain available-for-sale ABSs also reduced due to a slowing in the rate of anticipated losses in the underlying collateral pools.

In CMB, the reduction in loan impairment charges and other credit risk provisions was largely due to an improvement in the UK property, retail and services sectors, with reductions also seen in our Continental European businesses. The improvement in economic conditions across the region and the effect of low interest rates also resulted in lower delinquencies in the PFS portfolios.

Operating expenses in 2010 included one-off payroll and bonus taxes in the UK and France on certain bonuses paid in respect of 2009 totalling US\$324m, primarily in GB&M. Operating expenses in 2009 included an accounting

gain of US\$480m (US\$499m as reported) related to a change in the delivery of certain staff benefits in the main UK pension scheme. Excluding these items, operating expenses were 8% higher than in 2009. This was driven by continued strategic investments in people and infrastructure to support our customers, drive future growth and deliver sustainable long-term reductions in our cost base by re-engineering business processes. In addition, rental expenses increased following the sale and leaseback of our headquarters buildings in London and Paris.

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Report of the Directors: Operating and Financial Review (continued)**2009 compared with 2008**

Economic background

The **UK** economy suffered a sharp contraction during the course of 2009, although evidence from the final months of the year suggested that some growth had resumed. Gross Domestic Product (**GDP**) fell by 5% in 2009 – the sharpest contraction in over 60 years – after a 0.5% increase in 2008. Weakness affected most sectors of the economy, and the unemployment rate hit a 13-year high of 7.9% in July 2009, although some stabilisation of labour market conditions was apparent towards the end of the year. Consumer Price Index (**CPI**) inflation reached a five-year low of 1.1% in September 2009 before moving towards the Bank of England’s 2% target by the end of the year. Nominal house prices appreciated modestly during the second half of 2009, although indicators of housing market activity remained at relatively weak levels. After reducing interest rates to just 0.5% in March 2009, the Bank of England launched the Asset Purchase Facility in an attempt to improve the circulation of credit throughout the economy and support expectations of future economic activity.

The **eurozone** economy also performed poorly during 2009, with GDP falling by 4% following a 0.5% expansion in 2008. Much of this weakness was concentrated in the early months of 2009 and growth resumed in the third quarter, helped by a variety of fiscal stimulus programmes and a rebuilding of inventory levels. Consumer spending proved relatively resilient in early 2009, boosted by a number of purchase incentive schemes, and some weakness was observed as these programmes expired. Unemployment rose to an 11-year high of 10% in December 2009, while CPI temporarily turned negative during the third quarter of the year. The European Central Bank cut interest rates by 150 basis points to finish the year at 1%.

Review of performance

Our European operations reported a pre-tax profit of US\$4.0bn, compared with US\$10.9bn in 2008. This decline was largely caused by movement in the fair value attributable to credit spread on our own debt. A US\$2.8bn expense in 2009 following stabilisation in financial markets and a narrowing of credit spreads largely reversed the US\$3.1bn income recognised in 2008, giving a US\$5.9bn year on year movement. Also included within these results was a gain on the sale of the residual stake in the UK card merchant acquiring business to Global Payments Inc. of US\$280m in June 2009. This followed a

US\$425m gain realised in 2008 on the sale of the first tranche. Excluding these gains on sale, the profit on disposal of the French regional banks in July 2008 and the reversal of movements in the fair value of own debt, underlying pre-tax profits grew by US\$3.0bn or 83%. This was driven by robust performances in our European GB&M businesses, in particular from the non-recurrence of significant credit-related write-downs taken in 2008 and outstanding results in Rates and Balance Sheet Management. Deterioration in the economic environment and higher unemployment levels led to a rise in loan impairment charges in both PFS and CMB. HSBC Bank continued to provide lending services to its customers while maintaining effective credit control and strengthening collection practices and systems.

Net interest income increased by 43%, with Balance Sheet Management revenues in GB&M rising robustly. This resulted from the early positioning of our balance sheet in anticipation of decisions by central banks to maintain a low base rate environment. Net interest income also benefited from a reduction in the cost of funding trading activities as interest rates fell. Conversely, the PFS and CMB businesses and payments and cash management were adversely affected by continued margin compression following interest rate reductions in late 2008 and early 2009.

Mortgage balances increased as we gained market share in the UK through the success of a new Rate Matcher mortgage promotion and other campaigns launched in line with our secured lending growth strategy. In 2009, our UK bank more than met its commitment to make £15bn (US\$24.7bn) of new mortgage lending available to borrowers. In CMB, net lending fell compared with 2008 as a result of muted customer demand. Utilisation of committed overdraft

facilities provided by HSBC in the UK to commercial customers was only 40% at the end of 2009, illustrating the potential availability of credit when customer demand resumes. Across most businesses, asset balances declined reflecting reduced customer demand for credit, increased debt issuance as the bond markets reopened in 2009 and our diminished appetite for unsecured lending in Europe. Asset spreads widened, most notably in the UK and Turkey, as funding costs fell in the low interest rate environment and market pricing of corporate lending increased.

Throughout 2009, we worked to retain and build on the personal and commercial banking deposit bases gained in the last quarter of 2008 in the face of fierce competition and the narrowing of spreads across the region following interest rate cuts.

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)

Net fee income fell by 4%. The overall reduction in fees was a consequence of the part-disposal of the UK card merchant acquiring business to a joint venture in 2008 and lower insurance income following the closure of our consumer finance branch network in the UK and reduced sales of discontinued products. In GPB, lower equity brokerage commissions and reduced performance and management fees reflected subdued investor sentiment for risk and structured products; this, together with stock market declines, reduced the average value of funds under management during the year.

We generated higher underwriting fees than in 2008 from increased government and corporate debt issuances, and by taking market share in equity capital markets issues as corporates and financial institutions restructured their balance sheets by raising share capital. As part of our wealth management strategy, we continued to grow our Premier customer base and successfully launched the World Selection fund in the UK which raised US\$1.5bn. In France, the Premier customer base grew by over 10% as HSBC brand awareness increased.

Trading income increased by 23% to US\$5.5bn due to strong revenues across core businesses. Rates reported a significant increase in income driven by a growth in market share, higher client trading volumes and wider bid-offer spreads. Similarly, revenue in the Credit trading business also rose as credit prices improved and client activity increased with the return of liquidity to the market. Foreign exchange revenue fell, however, reflecting a combination of reduced customer volumes and relatively low market volatility when compared with the exceptional experience of 2008.

Trading income also benefited from significantly lower write-downs on legacy positions in Credit trading, leveraged and acquisition financing and monoline exposures, and from the non-recurrence of a reported US\$854m loss in 2008 following the fraud at Madoff Securities. These benefits were partly offset by losses on structured liabilities as credit spreads narrowed (compared with gains in 2008) and a reduction in net interest income on trading activities. This was due to the decline in interest rates, which also contributed to the reduction in the cost of funding trading activities as reported in *Net interest income*. The tightening of credit spreads also led to a reduction in the carrying value of credit default swap transactions held as hedges in parts of the Global Banking portfolio. In 2008, gains were reported on these credit default swaps following widening credit spreads.

We incurred a net expense of US\$1.4bn on *financial instruments designated at fair value*, compared with income in 2008. Gains on the fair value of assets held to meet liabilities under insurance and investment contracts were recognised as equity markets recovered from declines sustained in 2008. To the extent that these gains were attributed to policyholders holding either insurance contracts or investment contracts with DPF, there was a corresponding increase in *net insurance claims incurred and movement in liabilities to policyholders*.

Gains less losses from financial investments were US\$192m lower than in 2008 due to the non-recurrence of certain disposals in that year, including MasterCard shares, private equity investments and the remaining stake in the Hermitage Fund.

Net earned insurance premiums decreased by 12%. In the UK demand for the insurance-linked Guaranteed Income Bond fell as we offered more favourable rates on an alternative non-insurance deposit product, giving rise to a US\$1.1bn decrease in insurance premium income, with a corresponding decrease in *Net insurance claims incurred and movement in liabilities to policyholders*. Excluding the effect of a significant re-insurance transaction in 2008 which passed insurance premiums to a third-party reinsurer, net premiums in France increased despite a significant reduction in the distribution network following the disposal of the regional banks in July 2008.

Other operating income increased by 45%, mainly due to a US\$576m gain on the sale and leaseback of 8 Canada Square in London which was effected through the disposal of our entire shareholding in the company which was the legal owner of the building and long leasehold interest in 8 Canada Square. In 2008, we reported a gain of US\$416m representing the equity deposit on a previously negotiated sale of the building which ultimately did not complete. In

addition, a change in mortality assumptions in France resulted in increased PVIF of long-term insurance business. The growth in revenue also reflected the non-recurrence of costs associated with the support of money market funds in the global asset management business in 2008. Offsetting this was the non-recurrence of a favourable embedded value adjustment following the introduction of enhanced benefits to our existing pension products in the UK in 2008, and lower gains on the sale and leaseback of branches.

Net insurance claims incurred and movement in liabilities to policyholders increased by US\$2.5bn. The majority of the movement was due to the change

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)

in liabilities to policyholders reported above in Financial instruments designated at fair value , and the large one-off reinsurance transaction in France in 2008. In addition, an increase of US\$310m in claims reserving was required to reflect a higher incidence and severity of insurance claims in the UK motor underwriting business and a higher incidence of credit protection claims through the reinsurance business in Ireland. Risk mitigation measures implemented in 2009 included the decision to cease originations of UK motor insurance business. This was partly offset by the decrease in liabilities following reduced sales of the personal customer bond product offering noted above.

Loan impairment charges and other credit risk provisions rose by 66% to US\$5.6bn as the impact of weaker economic conditions across the region fed through to higher delinquency and default. In GB&M, loan impairment charges and credit risk provisions increased, with the charges concentrated among a small number of clients in the financial and property sectors. The emergence in the year of cash flow impairment on certain asset-backed debt securities held within the available-for-sale portfolios added US\$1.1bn to the charge. Impairment booked on these exposures reflects mark-to-market losses which we judge to be significantly in excess of the likely ultimate cash losses.

In CMB, loan impairment charges rose by US\$471m, again reflecting the economic downturn. Our commercial property portfolio in the UK declined during 2009, reflecting our efforts to reduce risk in this sector. In the personal sector, deterioration was most evident in the unsecured portfolios as unemployment rose. As a result of past management action, unsecured lending remained a small proportion of our personal lending portfolio, with the bulk of the portfolio secured in the form of residential mortgages. Despite some increase in losses in the residential sector, impairment charges as a percentage of total lending in this portfolio remained very low at 0.14%.

Operating expenses were held broadly in line with 2008. Excluding an accounting gain of US\$499m following a change in the basis of delivering death-in-service, ill health and early retirement benefits for some UK employees, operating expenses increased slightly despite efficiency benefits as higher performance-related awards were made to reflect GB&M's exceptional revenue and profit growth in selective businesses.

In PFS and CMB businesses, operational cost savings reflected the leverage of our global technology platforms and processes to reduce costs and improve customer experience, complemented by tight control over discretionary expenditure and a reduction in staff numbers. Payroll savings and lower Financial Services Compensation Scheme costs were partly offset by an increase in rental costs following the sale and leaseback of properties and higher regular defined benefit pension charges. In Europe, full time equivalent staff numbers fell by some 6,000 during the year.

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)*Profit/(loss) before tax and balance sheet data Europe*

	Personal Financial Services US\$m	Commercial Banking US\$m	Global Banking & Markets US\$m	2010 Global Private Banking US\$m	Other US\$m	Inter- segment elimination⁵⁶ US\$m	Total US\$m
<i>Profit/(loss) before tax</i>							
Net interest income/(expense)	5,536	2,774	2,936	871	(654)	(213)	11,250
Net fee income	2,016	1,570	1,863	883	39		6,371
Trading income/(expense) excluding net interest income	(7)	3	1,542	185	(262)		1,461
Net interest income/(expense) on trading activities	(1)	19	1,127	21	23	213	1,402
Net trading income/(expense) ⁴⁹	(8)	22	2,669	206	(239)	213	2,863
Changes in fair value of long- term debt issued and related derivatives					(365)		(365)
Net income/(expense) from other financial instruments designated at fair value	496	113	(23)		61		647
Net income/(expense) from financial instruments designated at fair value	496	113	(23)		(304)		282
Gains less losses from financial investments	29		460	(7)	4		486
Dividend income		1	16	2	1		20
Net earned insurance premiums	3,800	278			(11)		4,067
Other operating income	165	163	839	7	754	189	2,117

Total operating income/(expense)	12,034	4,921	8,760	1,962	(410)	189	27,456
Net insurance claims ⁵⁷	(4,364)	(342)					(4,706)
Net operating income/(expense)⁴⁶	7,670	4,579	8,760	1,962	(410)	189	22,750
Loan impairment (charges)/recoveries and other credit risk provisions	(1,217)	(997)	(783)	(26)	3		(3,020)
Net operating income/(expense)	6,453	3,582	7,977	1,936	(407)	189	19,730
Total operating expenses	(5,166)	(2,378)	(5,265)	(1,296)	(1,151)	(189)	(15,445)
Operating profit/(loss)	1,287	1,204	2,712	640	(1,558)		4,285
Share of profit in associates and joint ventures	2	1	14				17
Profit/(loss) before tax	1,289	1,205	2,726	640	(1,558)		4,302
	%	%	%	%	%		%
Share of HSBC's profit before tax	6.8	6.3	14.3	3.4	(8.2)		22.6
Cost efficiency ratio	67.4	51.9	60.1	66.1	(280.7)		67.9
<i>Balance sheet data⁴⁵</i>							
	US\$m	US\$m	US\$m	US\$m	US\$m		US\$m
Loans and advances to customers (net)	145,063	91,744	170,375	27,629	988		435,799
Total assets	202,431	111,356	965,462	76,631	65,824	(172,177)	1,249,527
Customer accounts	168,979	96,597	169,873	56,114			491,563

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Report of the Directors: Operating and Financial Review (continued)

Europe	Personal		Global Banking & Markets	2009 Global Private Banking	Other	Inter- segment elimination ⁵⁶	Total
	Financial Services US\$m	Commercial Banking US\$m	US\$m	US\$m	US\$m	US\$m	US\$m
<i>Profit/(loss) before tax</i>							
Net interest income/(expense)	5,413	2,739	4,367	949	(525)	(675)	12,268
Net fee income	1,949	1,679	1,670	883	86		6,267
Trading income excluding net interest income	34	3	2,267	175	382		2,861
Net interest income/(expense) on trading activities	(1)	17	1,869	23	15	675	2,598
Net trading income ⁴⁹	33	20	4,136	198	397	675	5,459
Changes in fair value of long- term debt issued and related derivatives					(2,746)		(2,746)
Net income/(expense) from other financial instruments designated at fair value	1,012	133	375		(199)		1,321
Net income/(expense) from financial instruments designated at fair value	1,012	133	375		(2,945)		(1,425)
Gains less losses from financial investments	20	2	25	5	(2)		50
Dividend income	2	1	26	3	(3)		29
Net earned insurance premiums	3,975	253	(2)		(3)		4,223
Other operating income	182	373	670	28	914	95	2,262
Total operating income/(expense)	12,586	5,200	11,267	2,066	(2,081)	95	29,133

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Net insurance claims ⁵⁷	(5,221)	(365)			(3)		(5,589)
Net operating income/(expense) ⁴⁶	7,365	4,835	11,267	2,066	(2,084)	95	23,544
Loan impairment charges and other credit risk provisions	(1,992)	(1,267)	(2,277)	(29)	(3)		(5,568)
Net operating income/(expense)	5,373	3,568	8,990	2,037	(2,087)	95	17,976
Total operating expenses	(5,062)	(2,294)	(4,447)	(1,183)	(907)	(95)	(13,988)
Operating profit/(loss)	311	1,274	4,543	854	(2,994)		3,988
Share of profit in associates and joint ventures	1	18	2				21
Profit/(loss) before tax	312	1,292	4,545	854	(2,994)		4,009
	%	%	%	%	%		%
Share of HSBC's profit before tax	4.4	18.3	64.2	12.1	(42.3)		56.7
Cost efficiency ratio	68.7	47.4	39.5	57.3	(43.5)		59.4
<i>Balance sheet data</i> ⁴⁵							
	US\$m	US\$m	US\$m	US\$m	US\$m		US\$m
Loans and advances to customers (net)	147,760	89,084	176,123	25,541	973		439,481
Total assets	208,669	111,874	981,831	76,871	84,010	(194,655)	1,268,600
Customer accounts	165,161	102,249	169,390	58,213	6		495,019

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)

Europe	Personal Financial Services US\$m	Commercial Banking US\$m	Global Banking & Markets US\$m	2008 Global Private Banking US\$m	Other US\$m	Inter- segment elimination ⁵⁶ US\$m	Total US\$m
<i>Profit/(loss) before tax</i>							
Net interest income/(expense)	6,464	3,435	3,488	1,046	(459)	(4,278)	9,696
Net fee income	2,612	2,025	1,763	1,020	72		7,492
Trading income/(expense) excluding net interest income	47	71	1,513	198	(138)		1,691
Net interest income/(expense) on trading activities		12	(655)	14	17	4,278	3,666
Net trading income/(expense) ⁴⁹	47	83	858	212	(121)	4,278	5,357
Changes in fair value of long- term debt issued and related derivatives					2,939		2,939
Net income/(expense) from other financial instruments designated at fair value	(1,634)	(214)	(611)		633		(1,826)
Net income/(expense) from financial instruments designated at fair value	(1,634)	(214)	(611)		3,572		1,113
Gains less losses from financial investments	281	132	(30)	62	(27)		418
Dividend income	35	74	25	5	(9)		130
Net earned insurance premiums	4,927	391			(19)		5,299
Gains on disposal of French regional banks					2,445		2,445
Other operating income	230	620	398	16	832		2,096

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Total operating income	12,962	6,546	5,891	2,361	6,286		34,046
Net insurance claims ⁵⁷	(3,224)	(143)					(3,367)
Net operating income ⁴⁶	9,738	6,403	5,891	2,361	6,286		30,679
Loan impairment charges and other credit risk provisions	(1,971)	(867)	(875)	(38)	(3)		(3,754)
Net operating income	7,767	5,536	5,016	2,323	6,283		26,925
Total operating expenses	(6,107)	(2,830)	(4,823)	(1,325)	(987)		(16,072)
Operating profit	1,660	2,706	193	998	5,296		10,853
Share of profit/(loss) in associates and joint ventures	(2)	16	2				16
Profit before tax	1,658	2,722	195	998	5,296		10,869
	%	%	%	%	%		%
Share of HSBC's profit before tax	17.8	29.2	2.1	10.7	56.9		116.7
Cost efficiency ratio	62.7	44.2	81.9	56.1	15.7		52.4
<i>Balance sheet data</i> ⁴⁵							
	US\$m	US\$m	US\$m	US\$m	US\$m		US\$m
Loans and advances to customers (net)	126,909	87,245	185,818	25,722	497		426,191
Total assets	171,962	107,495	1,180,759	84,485	64,423	(217,075)	1,392,049
Customer accounts	145,411	91,188	199,687	66,007	183		502,476

For footnotes, see page 83.

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)**Hong Kong**

HSBC's principal banking subsidiaries in Hong Kong are The Hongkong and Shanghai Banking Corporation Limited and Hang Seng Bank Limited. The former is the largest bank incorporated in Hong Kong and is our flagship bank in the Asia-Pacific region. It is one of Hong Kong's three note-issuing banks, accounting for more than 65% by value of banknotes in circulation in 2010.

	2010 US\$m	2009 US\$m	2008 US\$m
Net interest income	4,246	4,195	5,698
Net fee income	2,962	2,669	2,580
Net trading income	1,312	1,225	1,193
Other income	1,682	1,378	683
Net operating income⁴⁶	10,202	9,467	10,154
Impairment charges ⁴⁷	(114)	(500)	(765)
Net operating income	10,088	8,967	9,389
Total operating expenses	(4,431)	(3,946)	(3,943)
Operating profit	5,657	5,021	5,446
Income from associates ⁴⁸	35	8	15
Profit before tax	5,692	5,029	5,461
Cost efficiency ratio	43.4%	41.7%	38.8%
Year-end staff numbers	29,171	27,614	29,330

Best Bank in Hong Kong
(*Euromoney Awards for Excellence 2010*)
**Market leadership in mortgages,
cards, life insurance
and deposits**
64%

**growth in
commercial lending balances**

For footnotes, see page 83.

The commentary on Hong Kong is on an underlying basis unless stated otherwise.

Economic background

Relatively low interest rates and rapid growth in demand from mainland China contributed to Hong Kong's economic recovery in 2010. GDP in the year was 6.8% higher than in 2009. A revival in both employment and wage growth helped to boost consumer demand. Inflationary pressures began to emerge in the second half of the year with the annual rate of CPI inflation rising to 3.1% in December. The government initiated a number of measures in November aimed at restricting the pace of price increases in the property market.

Review of performance

Our operations in Hong Kong reported pre-tax profits of US\$5.7bn compared with US\$5.0bn in 2009, an increase of 13%. On an underlying basis, excluding accounting gains arising from the reclassification of Bao Viet as an associate and following the sale of HSBC Private Equity (Asia) Ltd, profit before tax increased by 11%.

The increase in profitability was driven by strong revenue growth, particularly in investment and insurance product sales and trade-related fees, as we capitalised on the improved economic conditions. Lending balances rose, most notably in CMB and GB&M following a recovery in trade flows and strong economic growth. Customer deposit balances increased, reflecting growth in customer numbers in PFS and CMB. Loan impairment charges were significantly lower than in 2009 across all customer groups, reflecting an improvement in credit conditions. Revenue growth was in part offset by an increase in staff and IT costs driven by business expansion to maintain our strong market position.

We retained our market leadership in residential mortgages, credit cards, life insurance and deposits. The Premier customer base increased by 31% compared with 31 December 2009 to more than 500,000 customers. The Advance proposition, which was launched in early 2010, had a customer base of over 670,000 by the end of the year. In life insurance, we retained the number one market share position for new business annualised premiums as a result of successful sales activity and customer demand and a strategy targeted towards the high net worth customer segment. CMB's cross-border referrals more than doubled with the increase in trade flows from mainland China. We continued the development of offshore renminbi-related products and maintained our position as a market leader for renminbi products in Hong Kong.

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)*Profit/(loss) before tax by customer group and global business*

	2010	2009	2008
	US\$m	US\$m	US\$m
Personal Financial Services	2,918	2,728	3,428
Commercial Banking	1,352	956	1,315
Global Banking and Markets	1,430	1,507	1,436
Global Private Banking	227	197	237
Other	(235)	(359)	(955)
	5,692	5,029	5,461

Net interest income was broadly in line with 2009, as strong loan growth was partly offset by lower spreads resulting from competitive pressures and the low interest rate environment. In Balance Sheet Management, net interest income decreased as yield curves flattened, higher yielding positions matured and funds were reinvested at lower rates.

The recovery in trade volumes in 2010 and the pursuit of CMB's leading international bank for business strategy resulted in significant growth in commercial lending, notably in commercial, industrial and trade related lending. To a lesser extent, growth was also noted in commercial real estate, supported by a buoyant property market. Average personal lending balances also rose, driven by strong growth in residential mortgage lending, where we continued to lend conservatively with average loan-to-value ratios of 55% on new mortgage drawdowns and an estimated 38% on the overall portfolio.

Asset spreads narrowed as a result of competitive pressures, particularly in trade-related lending and HIBOR-linked residential mortgages.

The growth in customer numbers in the Premier proposition in PFS and new-to-bank customers in CMB resulted in increased customer deposits. The benefit of the higher average deposit balances was limited by narrower deposit spreads as interest rates remained at historically low levels.

Net fee income increased by 11%, primarily due to an increase in sales of investment products driven by improved market sentiment and successful sales campaigns, and growth in trade-related fees and income from Payments and Cash Management as volumes improved. Fees from funds under management also grew as a result of higher net inflows and improved fund performance, while underwriting fees rose due to several significant initial public offerings (IPOs) and loan syndications concluded in 2010.

Net trading income was 7% higher than in 2009. Increased holdings of debt securities led to a rise in net interest income from trading activities. Foreign exchange revenues benefited from increased turnover due to high levels of client demand. This was partly offset by lower revenues from Credit trading, following the strong results achieved in 2009 as credit spreads narrowed, and from Rates trading as market volatility reduced in 2010.

Net income from financial instruments designated at fair value was US\$384m compared with US\$784m in 2009. The movement was primarily due to lower revaluation gains in 2010 on assets held to support linked insurance liabilities, where the value of our liabilities to policyholders is determined in line with the value of supporting assets. To the extent that these lower investment gains were attributed to policyholders, there was a corresponding decrease in *Net insurance claims incurred and movement in liabilities to policyholders*.

Net earned insurance premiums grew by 18% to US\$4.3bn as successful sales campaigns drove strong growth, particularly in deferred annuity and unit-linked products. A life insurance product targeted at high net worth individuals also performed well. Growth in the insurance business resulted in a related increase in Net insurance claims incurred and movement in liabilities to policyholders .

Other operating income increased by 21% to US\$1.5bn due to an increase in PVIF reflecting higher life insurance sales, partly offset by the non-recurrence of a gain on sale of a property in 2009.

Loan impairment charges and other credit risk provisions decreased by 77% to US\$114m, reflecting the recovery in economic conditions. Lower specific impairment charges in CMB and GB&M were incurred as credit conditions improved and loan impairment charges fell in PFS, mainly on unsecured lending as unemployment and bankruptcy levels fell.

Operating expenses rose by 12% as the business grew and the economy recovered. Staff costs grew as we recruited in a competitive market and from general wage increases, while bonuses rose in line with the strong business performance. Marketing costs rose notably in PFS due to the launch of several large campaigns, including Advance and credit cards promotions and rising transaction volumes led to higher back office and support costs.

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)**2009 compared with 2008**

Economic background

The performance of the **Hong Kong** economy proved variable during the course of 2009, with a robust recovery developing after a sharp contraction was recorded during the first quarter of the year. GDP in 2009 fell by 2.7% after growth of 2.1% in 2008. Unemployment rose during the first half of 2009, before falling slightly to end the year at 4.9%, a figure still well below the average of the past 10 years. The CPI profile proved volatile during the course of the year, turning negative between June and August before rising to 1.3% by December 2009, although these movements largely reflected the trends of food and energy prices. The Hong Kong Monetary Authority held the base rates steady at 0.5% throughout the course of the year. Asset price performance proved unusually volatile as the Hang Seng Index recovered strongly from a weak start to 2009 to record a 52% increase during the year.

Review of performance

Our operations in Hong Kong reported pre-tax profits of US\$5.0bn compared with US\$5.5bn in 2008, an 8% decline on both a reported and an underlying basis.

The decrease in profits came from lower revenue, which resulted from compressed deposit spreads in a near-zero interest rate environment. This loss of revenue was partly offset by significantly lower loan impairment charges and other credit risk provisions during 2009, and a recovery in trade activity triggered by an improvement in regional economic conditions in the second half of the year.

Despite continuing economic challenges, performance remained robust, and was underpinned by our market-leading share in deposits, residential mortgages, cards and insurance. In particular, we consolidated our position as Hong Kong's leading bancassurer, growing the value of new life insurance business by 38%. In residential mortgages, business growth was combined with conservative loan-to-value ratios on new business.

Net interest income declined by 27% to US\$4.2bn, driven by significant deposit spread compression as HIBOR and LIBOR remained low throughout 2009. Selective repricing of customer loans helped to mitigate the impact of lower rates on lending spreads and the continued increase in customer account balances has positioned us to benefit from economic recovery and a resulting widening of deposit spreads.

Average customer lending balances remained broadly in line with 2008, as lower CMB balances, which reflected the reduction in exports in the first half of 2009, were broadly offset by higher lending in PFS and GB&M. As the regional economy rebounded, trade volumes and CMB lending activity increased in the second half of the year. Throughout this challenging period for trade, we continued to support local business through our HK\$20bn (US\$2.6bn) global loan fund for smaller businesses. These facilities were fully utilised by over 8,600 companies at 31 December 2009.

As residential property prices increased, personal lending volumes rose, and we consolidated our mortgage market share by originating significant volumes of new mortgages. We led this market with a 38% share of new loan drawdowns with an average loan-to-value ratio of 58% on new business. Asset spreads improved as a result of selective risk-based repricing, notably in cards, while funding costs fell in the low interest rate environment.

We continued to increase market share in savings and deposit accounts, and balances grew following a series of deposit acquisition campaigns. In PFS, customer account balances rose by 15% and Premier customer numbers grew to over 380,000. Strong growth in CMB was driven by a rise in customer numbers, also supported by a series of deposit acquisition campaigns and increased liquidity in the region.

Overall, deposit balances grew by 10%. Liability spreads remained under severe pressure throughout 2009, however.

Net fee income increased by 3% with an increase in IPO underwriting fees in the second half of the year, triggered by improved investor sentiment and a recovery in equity markets. PFS customers' preference for deposit products

rather than equity-linked products in the first half of the year reversed as equity markets recovered in the second half of 2009, resulting in a recovery in revenue generated from unit trusts, wealth management, custody and other investment products. Similarly, the increase in trade flows in the second half of 2009 affected trade-related fee income in CMB.

Trading income increased by 2%, primarily due to increased volumes of bond trading and wider margins on market making activities. The non-recurrence of US\$0.2bn of write-downs on a legacy monoline exposure also contributed to the rise. Foreign exchange trading revenue decreased from the exceptional results reported in 2008, reflecting the lower market volatility and a decline in customer

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)

volumes. Interest on trading assets declined due to a reduced holding of trading debt securities.

Income of US\$0.8bn was generated from *financial instruments designated at fair value*, compared with an expense of US\$1.2bn in 2008. The positive movement in fair value was primarily driven by equity market-related gains in unit-linked insurance products. To the extent that these gains were attributed to policyholders, there was a corresponding increase in *net insurance claims incurred and movement in liabilities to policyholders*.

Net earned premiums increased by 13% to US\$3.7bn due to strong sales of both existing and new products, including a life insurance product designed for high net worth individuals, all of which contributed to a rise in market share. The proportion of regular premium policies grew and sales of investment-linked insurance products began to improve in the second half of the year. We retained our market leadership position in the regular-premium individual-life new business. The growth in our insurance business also resulted in higher net insurance claims incurred and movement in liabilities to policyholders.

Gains less losses from financial investments moved from a loss of US\$310m to a net gain of US\$9m, mainly due to the non-recurrence of impairments against our available-for-sale equity investments following declines in market valuations in 2008. The loss recognised in 2008 on the equity investments concerned was partially recovered in 2009 but this gain was reflected in reserves rather than reversing through the income statement.

Other operating income of US\$1.3bn was 55% higher than in 2008, reflecting a positive movement in PVIF driven largely by an increase in insurance sales to new customers. We recognised a gain of US\$110m in respect of the disposal of a property in Hong Kong.

Loan impairment charges and other credit risk provisions fell by 35% to US\$0.5bn, as the credit environment was more stable in 2009 following deterioration in the second half of 2008. The high level of credit risk provisions and loan impairment charges taken in 2008 against financial institutions and export-led customers moderated in 2009 as credit conditions recovered and international trade volumes improved.

A rise in unemployment and in bankruptcy petitions led to increased impairment charges against unsecured lending in PFS, though bankruptcy levels improved in the second half of the year. Property prices increased during 2009 and mortgage lending remained well secured with conservative loan-to-value ratios and origination subject to tight internal and regulatory guidelines.

Operating expenditure was held in line with 2008 as higher staff costs were offset by lower general and administrative costs. The increase in staff costs, driven by higher performance-related pay, was partly offset by reduced staff numbers. Non-staff costs fell as marketing expenditure was reduced and operational efficiencies improved as a result of our increased use of direct channels.

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)*Profit/(loss) before tax and balance sheet data Hong Kong*

	Personal Financial Services US\$m	Commercial Banking US\$m	Global Banking & Markets US\$m	2010 Global Private Banking US\$m	Inter- segment Other elimination ⁵⁶ US\$m	Total US\$m
<i>Profit/(loss) before tax</i>						
Net interest income/(expense)	2,604	1,106	915	173	(463)	4,246
Net fee income	1,521	634	630	163	14	2,962
Trading income/(expense) excluding net interest income	197	121	681	120	(12)	1,107
Net interest income on trading activities	4		100		12	205
Net trading income ⁴⁹	201	121	781	120	89	1,312
Changes in fair value of long- term debt issued and related derivatives					(2)	(2)
Net income/(expense) from other financial instruments designated at fair value	328	(10)	61		1	380
Net income/(expense) from financial instruments designated at fair value	328	(10)	61		(1)	378
Gains less losses from financial investments			56	1	41	98
Dividend income		1	12		17	30
Net earned insurance premiums	3,655	665	12			4,332
Other operating income	503	68	166	12	1,140	1,606

Total operating income	8,812	2,585	2,633	469	748	(283)	14,964
Net insurance claims ⁵⁷	(4,193)	(559)	(10)				(4,762)
Net operating income⁴⁶	4,619	2,026	2,623	469	748	(283)	10,202
Loan impairment charges and other credit risk provisions	(76)	(28)	(10)				(114)
Net operating income	4,543	1,998	2,613	469	748	(283)	10,088
Total operating expenses	(1,630)	(653)	(1,187)	(242)	(1,002)	283	(4,431)
Operating profit/(loss)	2,913	1,345	1,426	227	(254)		5,657
Share of profit in associates and joint ventures	5	7	4		19		35
Profit/(loss) before tax	2,918	1,352	1,430	227	(235)		5,692
	%	%	%	%	%		%
Share of HSBC's profit before tax	15.3	7.1	7.5	1.2	(1.2)		29.9
Cost efficiency ratio	35.3	32.2	45.3	51.6	134.0		43.4
<i>Balance sheet data⁴⁵</i>							
	US\$m	US\$m	US\$m	US\$m	US\$m		US\$m
Loans and advances to customers (net)	50,983	48,670	34,491	4,760	1,787		140,691
Total assets ⁶¹	76,665	55,030	223,492	20,598	62,486	(8,706)	429,565
Customer accounts	176,960	71,209	29,388	19,241	686		297,484

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Report of the Directors: Operating and Financial Review (continued)

Hong Kong	Personal		Global Banking & Markets US\$m	2009 Global Private Banking US\$m	Inter- segment elimination ⁵⁶		Total US\$m
	Financial Services US\$m	Commercial Banking US\$m			Other US\$m	US\$m	
<i>Profit/(loss) before tax</i>							
Net interest income/(expense)	2,577	938	1,150	212	(558)	(124)	4,195
Net fee income	1,410	530	563	125	41		2,669
Trading income/(expense) excluding net interest income	186	92	792	91	(93)		1,068
Net interest income on trading activities	3		16		14	124	157
Net trading income/(expense) ⁴⁹	189	92	808	91	(79)	124	1,225
Changes in fair value of long- term debt issued and related derivatives					(3)		(3)
Net income/(expense) from other financial instruments designated at fair value	707	(46)	138		(11)		788
Net income/(expense) from financial instruments designated at fair value	707	(46)	138		(14)		785
Gains less losses from financial investments	80	18	(108)		19		9
Dividend income	1	1	10		16		28
Net earned insurance premiums	3,161	500	13				3,674
Other operating income	346	64	59	10	1,062	(267)	1,274
Total operating income	8,471	2,097	2,633	438	487	(267)	13,859

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Net insurance claims ⁵⁷	(3,979)	(404)	(9)				(4,392)
Net operating income ⁴⁶	4,492	1,693	2,624	438	487	(267)	9,467
Loan impairment (charges)/ recoveries and other credit risk provisions	(203)	(168)	(131)	1	1		(500)
Net operating income	4,289	1,525	2,493	439	488	(267)	8,967
Total operating expenses	(1,566)	(570)	(987)	(242)	(848)	267	(3,946)
Operating profit/(loss)	2,723	955	1,506	197	(360)		5,021
Share of profit in associates and joint ventures	5	1	1		1		8
Profit/(loss) before tax	2,728	956	1,507	197	(359)		5,029
	%	%	%	%	%		%
Share of HSBC's profit before tax	38.5	13.5	21.3	2.8	(5.1)		71.0
Cost efficiency ratio	34.9	33.7	37.6	55.3	174.1		41.7
<i>Balance sheet data</i> ⁴⁵							
	US\$m	US\$m	US\$m	US\$m	US\$m		US\$m
Loans and advances to customers (net)	43,869	28,217	21,991	3,361	1,943		99,381
Total assets ⁶¹	83,497	34,743	217,146	20,353	52,508	(9,004)	399,243
Customer accounts	166,445	62,146	26,650	19,474	726		275,441

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Report of the Directors: Operating and Financial Review (continued)

Hong Kong	Personal		Global Banking & Markets US\$m	2008 Global Private Banking US\$m	Inter- segment Other elimination ⁵⁶ US\$m		Total US\$m
	Financial Services US\$m	Commercial Banking US\$m					
<i>Profit/(loss) before tax</i>							
Net interest income/(expense)	3,381	1,498	1,524	214	(669)	(250)	5,698
Net fee income	1,441	548	414	163	14		2,580
Trading income excluding net interest income	143	79	483	120	30		855
Net interest/(expense) income on trading activities	11	1	244		(168)	250	338
Net trading income/(expense) ⁴⁹	154	80	727	120	(138)	250	1,193
Changes in fair value of long- term debt issued and related derivatives					3		3
Net income/(expense) from other financial instruments designated at fair value	(1,291)	(10)	39		68		(1,194)
Net income/(expense) from financial instruments designated at fair value	(1,291)	(10)	39		71		(1,191)
Gains less losses from financial investments	156	32	(109)		(388)		(309)
Dividend income	3	2	17		19		41
Net earned insurance premiums	3,047	181	17		2		3,247
Other operating income	132	38	101	8	906	(368)	817
Total operating income	7,023	2,369	2,730	505	(183)	(368)	12,076

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Net insurance claims ⁵⁷	(1,773)	(136)	(11)		(2)		(1,922)
Net operating income ⁴⁶	5,250	2,233	2,719	505	(185)	(368)	10,154
Loan impairment (charges)/recoveries and other credit risk provisions	(134)	(335)	(284)	(13)	1		(765)
Net operating income/(expense)	5,116	1,898	2,435	492	(184)	(368)	9,389
Total operating expenses	(1,691)	(584)	(1,000)	(255)	(781)	368	(3,943)
Operating profit/(loss)	3,425	1,314	1,435	237	(965)		5,446
Share of profit in associates and joint ventures	3	1	1		10		15
Profit/(loss) before tax	3,428	1,315	1,436	237	(955)		5,461
	%	%	%	%	%		%
Share of HSBC's profit before tax	36.9	14.1	15.4	2.6	(10.3)		58.7
Cost efficiency ratio	32.2	26.2	36.8	50.5	(422.2)		38.8
<i>Balance sheet data</i> ⁴⁵							
	US\$m	US\$m	US\$m	US\$m	US\$m		US\$m
Loans and advances to customers (net)	41,447	30,331	23,042	3,605	1,795		100,220
Total assets	75,419	36,428	233,187	28,800	66,192	(25,542)	414,484
Customer accounts	145,002	54,869	30,866	19,416	364		250,517

For footnotes, see page 83.

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)**Rest of Asia-Pacific**

We offer a full suite of banking and financial services in mainland China, mainly through our local subsidiary, HSBC Bank (China) Company Limited. We also participate indirectly in mainland China through our four associates.

Outside Hong Kong and mainland China, we conduct business in 22 countries and territories in the Rest of Asia-Pacific region, primarily through branches and subsidiaries of The Hongkong and Shanghai Banking Corporation, with particularly strong coverage in Australia, India, Indonesia, Malaysia and Singapore.

	2010 US\$m	2009 US\$m	2008 US\$m
Net interest income	3,828	3,539	3,937
Net fee income	1,932	1,557	1,867
Net trading income	1,618	1,606	2,042
Other income	1,854	1,301	1,135
Net operating income ⁴⁶	9,232	8,003	8,981
Impairment charges ⁴⁷	(439)	(896)	(852)
Net operating income	8,793	7,107	8,129
Total operating expenses	(5,143)	(4,450)	(4,704)
Operating profit	3,650	2,657	3,425
Income from associates ⁴⁸	2,252	1,543	1,297
Profit before tax	5,902	4,200	4,722
Cost efficiency ratio	55.7%	55.6%	52.4%
Year-end staff numbers	91,607	87,141	89,706

41%

growth in reported pre-tax profit
Leadership in renminbi
product development

**Significant and growing presence
in mainland China**

For footnotes, see page 83.

The commentary on Rest of Asia-Pacific is on an underlying basis unless stated otherwise.

Economic background

Economic activity accelerated in **mainland China**, building on the recovery which began in 2009. Annual GDP growth peaked at 11.9% in the first quarter of the year, as resilient domestic demand coincided with an acceleration in export growth as world demand recovered. Investment growth remained strong amid large scale government infrastructure projects and construction of public housing. Meanwhile, consumer spending was boosted by robust growth in employment and wages. In the final months of 2010, inflation became more of a concern, with the annual rate of CPI inflation rising to 4.6% in December. The People's Bank of China increased the commercial banking sector's required Statutory Deposit Ratio by 4.5 percentage points to 19.5% (for major banks) and 17.0% (for the rest) and raised the policy rate by 50 basis points over the course of the year. The renminbi exchange rate rose by 3% against the US dollar throughout the course of the year.

Japan's economic conditions improved in 2010, led mainly by a recovery in world trade, though unemployment remained at about 5% throughout the year. The Bank of Japan introduced a new programme of monetary stimulus in October 2010, aimed at curbing yen appreciation and reducing the deflationary pressures evident in the economy.

Elsewhere in the region, economies rebounded strongly, with growth in external demand a common feature. Comparing the third quarter of 2010 with the same period in 2009, GDP in **Taiwan** grew by 9.8%, in **South Korea** by 4.4% and in **India** by 8.9%. In the last, concerns emerged over the rate of wholesale price inflation, which rose to 8.4% in December. In **Singapore**, GDP growth was volatile as activity in the pharmaceutical sector fluctuated, contracting at an annualised rate of nearly 19% in the third quarter but rising 6.9% in the fourth quarter. **Malaysian** GDP, boosted by private consumption and exports, rose by 5.3% year on year in the third quarter, after surging 10.1% in the first quarter and 8.9% in the second quarter. In **Thailand**, the re-emergence of political risks in the second quarter of 2010 appeared not to dent household consumption or foreign direct investment. Foreign direct investment into **Indonesia** underpinned GDP growth of 5.8% in the third quarter. The economies of the **Philippines** and **Vietnam** also grew strongly. In **Australia** growth was more modest, in part because of a rise in the Reserve Bank of Australia's interest rate to 4.75% in the second half of the year. Activity in the mining sector continued to grow rapidly.

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Report of the Directors: Operating and Financial Review (continued)*Profit/(loss) before tax by country within customer groups and global businesses*

	Personal		Global	Global		
	Financial Services	Commercial Banking	Banking & Markets	Private Banking	Other	Total
	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m
2010						
Australia	59	96	95		8	258
India	(82)	71	507	4	179	679
Indonesia	12	94	116		(3)	219
Japan	(76)		119	(1)	(6)	36
Mainland China	839	833	683	(7)	217	2,565
Associates	973	746	443		188	2,350
Other mainland China	(134)	87	240	(7)	29	215
Malaysia	120	88	194		(1)	401
Singapore	126	87	143	84	84	524
South Korea	2	(4)	305		50	353
Taiwan	19	36	99		(7)	147
Vietnam	(7)	50	61		7	111
Other	54	205	262	1	87	609
	1,066	1,556	2,584	81	615	5,902
2009						
Australia	30	32	140		(4)	198
India	(219)	(41)	393	1	240	374
Indonesia	(24)	60	129		(11)	154
Japan	(79)		65	(4)	1	(17)
Mainland China	494	616	479	(7)	50	1,632
Associates	678	558	285			1,521
Other mainland China	(184)	58	194	(7)	50	111
Malaysia	88	53	140		5	286
Singapore	129	77	247	98	(9)	542
South Korea	(3)	(5)	342		25	359

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Taiwan	(3)	65	96		2	160
Vietnam	(8)	40	63		6	101
Other	58	167	225	2	(41)	411
	463	1,064	2,319	90	264	4,200
2008						
Australia	19	68	102		(13)	176
India	(155)	118	578	2	123	666
Indonesia	(22)	17	126			121
Japan	(88)	(1)	88	1	4	4
Mainland China	284	622	688	(5)	16	1,605
Associates	393	558	335			1,286
Other mainland China	(109)	64	353	(5)	16	319
Malaysia	94	96	171		8	369
Singapore	104	83	337	110	(37)	597
South Korea	(16)	(13)	304		38	313
Taiwan	(41)	45	179		(8)	175
Vietnam	(16)	32	63		(14)	65
Other	48	168	334	1	80	631
	211	1,235	2,970	109	197	4,722

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)**Review of performance**

Our operations in the Rest of Asia-Pacific region reported pre-tax profits of US\$5.9bn compared with US\$4.2bn in 2009, an increase of 41%. Reported profits included an accounting gain of US\$188m arising from the dilution of HSBC's shareholding in Ping An Insurance following its issue of share capital to a third party in 2010. On an underlying basis, which excludes this dilution gain, pre-tax profit rose by 29% as business volumes increased across many countries and all customer groups as the economic environment in the region improved.

The economic performance of the region was reflected in a recovery in trade volumes, an increase in our customers appetite for investment-related products, strong growth in lending balances and a significant decline in loan impairment charges. All these factors contributed to an increase in our profitability, as did a rise in our share of profit from associates in mainland China. Operating expenses increased to support this business growth.

During 2010 we continued to target growth, particularly in the key regional markets of mainland China, India, Indonesia, Singapore, Malaysia and Australia. We consolidated our position as the leading foreign bank in mainland China with 106 outlets in 27 cities, 16 rural bank outlets and 38 Hang Seng Bank outlets in 13 cities. We maintained our leadership in the development of renminbi products and now have renminbi capabilities in 36 countries across all six continents. In July 2010 we agreed to acquire a substantial part of The Royal Bank of Scotland Group plc's commercial and retail businesses in India. In Malaysia, four additional Amanah branches were opened.

Our focus on higher value segments was reflected in the Premier customer base in the region which grew by 33% while the Advance proposition was launched in nine markets, exceeding 660,000 customers by the year end. In CMB, we continued to build on our international connectivity, with cross-regional referrals nearly doubling as we pursued our objective to be the leading international business bank.

Net interest income was broadly in line with 2009 as strong loan growth was offset by narrower asset spreads in the face of strong competition. Higher average lending balances resulted from business growth in GB&M and CMB across the region, reflecting the recovery in trade activity. Average PFS lending balances also rose, mainly in the mortgage book, most notably in Australia, Singapore and Malaysia, as well as in Taiwan and mainland China, supported by successful marketing campaigns.

The narrower asset spreads were also the consequence of a shift to lower risk customers following the managed reduction of certain unsecured lending portfolios, particularly in India.

Average customer deposit balances grew, primarily in mainland China, Australia and Singapore as a result of a targeted strategy to expand the customer base.

Balance Sheet Management income declined from 2009 as higher yielding trades matured, interest rates generally remained low and yield curves flattened.

Net fee income was 16% higher. An improvement in equity markets and inflows of funds under management drove a significant increase in fee income in GB&M while, in CMB, the recovery in trade activity led to higher trade-related fees and credit facilities. In PFS, fee income also rose from the increased sales of investment and insurance products.

Net trading income declined by 7%, as reduced market volatility led to lower Rates trading income. In India, trading income further declined as gains achieved in 2009 from narrowing bond yields did not recur while in South Korea, lower trading revenues reflected the non-recurrence of one-off gains recognised in 2009. These were partly offset by higher foreign exchange income in mainland China and wider margins in India as a result of strong client volumes in the growing economies and a rise in interest income from trading activities resulting from increased holdings of debt securities.

Net income from financial instruments designated at fair value fell by US\$95m. The movement was due to lower revaluation gains in 2010 than in 2009 on assets held to support insurance contracts. To the extent that these lower investment gains were attributed to policyholders, there was a corresponding decrease in Net insurance claims

incurred and movement in liabilities to policyholders .

Gains less losses from financial investments were US\$141m compared with losses of US\$15m in 2009, as a result of a gain on disposal of an equity investment in a Singaporean property company and gains on sales of other available-for-sale investments. Impairments reported in 2009 did not recur in 2010.

Other operating income increased by 8% to US\$1.4bn, largely due to an increase in PVIF,

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Report of the Directors: Operating and Financial Review (continued)

reflecting higher life insurance sales in the region and recoveries against initial fair value on loan portfolios acquired with Bank Ekonomi in Indonesia and from The Chinese Bank Co., Ltd in Taiwan.

Net earned insurance premiums increased by 15% to US\$448m, largely due to higher sales in Malaysia, Taiwan and mainland China, primarily from successful product launches and marketing campaigns.

Growth in the insurance business resulted in a related increase in *Net insurance claims incurred and movement in liabilities to policyholders* which was more than offset by the decrease corresponding to the lower investment gains reported above in *Net income from financial instruments designated at fair value*.

Loan impairment charges and other credit risk provisions decreased by 55% to US\$439m. As economic and credit conditions improved across the region, loan impairment charges fell in PFS, most notably in India as certain unsecured lending portfolios were managed down, and fewer specific impairments were recognised in CMB. Partly offsetting this

improvement were specific impairment charges booked in GB&M.

Operating expenses increased by 8% to US\$5.1bn in support of business growth and to capitalise on the region's economic recovery. Examples were the continuing expansion of the branch network in mainland China and the opening of the new headquarters building in Shanghai, as well as local incorporation and expansion of the Taiwan operations. Staff numbers rose to support business expansion, particularly in the key regional markets of mainland China, Australia, Singapore and Indonesia. Business initiatives were supported by marketing campaigns in most markets and higher transaction volumes which led to increased processing costs.

Share of profit from associates and joint ventures in the region increased by 45%, with a higher contribution from Ping An Insurance driven by strong sales growth. The share of profit from Bank of Communications also increased due to growth in lending and higher fee income from cards, wealth management and settlement activity. Growth in lending and an increase in fee income led to a higher contribution from Industrial Bank.

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Report of the Directors: Operating and Financial Review (continued)**2009 compared with 2008**

Economic background

Growth in **mainland China** accelerated throughout the course of the year as the government's fiscal stimulus package helped offset weak levels of demand within key export markets. Overall GDP growth totalled 8.7% in 2009, down from 9.6% in 2008, although on a quarterly basis the annual rate of growth rose to a very high 10.7% in the final three months of the year. Industrial production also gathered momentum as the year progressed, while very strong levels of bank lending growth helped fixed asset investment expenditure to maintain a rapid pace of expansion throughout 2009. Consumer spending remained robust, with retail sales rising by 17.5% in the year. The annual CPI rate was negative throughout much of 2009, largely reflecting the earlier movements in food and energy prices, before accelerating to 1.9% in December 2009. The renminbi exchange rate was little changed against the US dollar throughout the course of the year.

Economic conditions proved difficult in **Japan** during 2009, although some signs of stabilisation did emerge following an extremely weak start to the year. First quarter GDP fell by 3.2% on a quarter-on-quarter basis, before gains of 1.3%, zero and 1.1% were recorded in the next three quarters, respectively. The unemployment rate rose from 4.3% in December 2008 to a record high of 5.7% in July 2009, before declining to finish the year at 5.1%. The Bank of Japan introduced a range of initiatives in January 2009 with the intention of improving financing conditions across the corporate sector, while fiscal stimulus packages were also implemented.

Elsewhere in Asia, most economies experienced a further year of uneven growth in 2009. Sharp economic contractions proved commonplace across the region during the early months of 2009 before economic recovery began, often helped by an aggressive loosening of both monetary and fiscal policy. Such trends were particularly evident in **Singapore** where, following a very weak start to 2009, a rapid rate of expansion was recorded during the second quarter, although GDP growth fell back into negative territory during the final months of the year. Growth proved much more stable in **India**, with GDP rising by 6.3% in the first three quarters of the fiscal year 2009/10 following a 5.7% expansion in the same period in 2008/09, helped by an aggressive reduction in interest rates and a sharp increase in government expenditure. Although growth slowed in 2009 in **Indonesia**, the 4.5% increase in GDP and the relative stability of growth

left the country as one of the region's better performers. Economic conditions proved very weak during the early months of 2009 in **Malaysia** as first quarter GDP fell by 6.2% on the same period in 2008, but a strong recovery, helped by an improvement in regional trade activity and a domestic stimulus package, placed fourth quarter GDP some 4.5% above the comparable figure from a year earlier. A recovery in both exports and domestic demand helped the **South Korean** economy to record a strong recovery from a very weak start to 2009, with GDP increasing slightly by 0.2% for the full year, following a 2.2% increase during 2008. Increased public expenditure helped the **Philippines** economy to return to growth following a weak start to 2009, with full year growth of 0.9% being recorded, down from 3.8% in 2008. **Taiwan**'s economy proved particularly vulnerable to the sharp fall in global trade activity during the early months of 2009, although the year-on-year rate of decline in GDP moderated as 2009 progressed, thanks in part to a recovery in consumer expenditure around the middle of the year. A substantial fiscal stimulus package in **Vietnam** contributed to improved growth momentum during the first half of 2009, although concerns over the deterioration in the trade position led to a devaluation of the currency and a tightening of monetary policy during the final weeks of the year. Full year 2009 GDP growth slowed slightly to 5.3% from 6.2% in 2008.

Review of performance

Our operations in the Rest of Asia-Pacific region reported a pre-tax profit of US\$4.2bn compared with US\$4.7bn in 2008, a decline of 11% or 8% on an underlying basis. The decline in regional performance was primarily attributable to the challenging economic conditions which resulted in deposit spread compression, lower fee income and credit

quality deterioration.

During 2009, we continued to build our presence in the region through organic growth, the acquisition of Bank Ekonomi, and strategic investments. The purchase of Bank Ekonomi nearly doubled our presence in Indonesia to over 200 outlets in 27 cities. We became the first foreign bank to incorporate locally in Vietnam in January 2009, creating the opportunity to widen the product range and increase distribution channels to customers. The integration of IL&FS Investsmart, subsequently rebranded to HSBC InvestDirect, has strengthened our network in India, allowing us to offer wealth management products through over 200 additional outlets. Building our mainland China business and renminbi capabilities continued to be a key focus, as

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Report of the Directors: Operating and Financial Review (continued)

demonstrated by the opening of onshore renminbi accounts in mainland China and the launch of renminbi trade settlement in seven ASEAN countries. 19 new HSBC branded outlets were opened in mainland China in 2009, as well as eight additional rural bank outlets and four new Hang Seng Bank branches, consolidating our position as the leading foreign bank in the country. We also launched a new jointly-owned life insurance company in mainland China, and announced the intention to establish a new cards joint venture with Bank of Communications to which over 11m cards in force will be transferred. In insurance, we expanded our regional coverage and increased our stake in Bao Viet in January 2010, allowing it to extend its position in the Vietnamese market.

Net interest income declined by 8% to US\$3.5bn, driven by deposit spread compression in the low interest rate environment and a decline in lending balances. This was partly offset by asset repricing, particularly in CMB.

Average lending balances fell in GB&M and CMB as a result of lower demand for financing as international trade volumes declined, especially in the first half of the year. Growth returned in the second half of the year as the volume of trade activity improved.

Customer deposits grew compared with 2008. PFS continued to successfully attract deposits and the acquisition of Premier customers was strong with the region growing customer numbers by 35% to over 580,000. Payments and cash management was adversely affected by the low interest rate environment.

Net fee income was 13% lower than in 2008, driven by a decline in income from funds under management and global custody. Fees from funds under management in Singapore, Japan and Taiwan declined as a result of weak investor sentiment and lower fee margins as customers moved away from equity investment products though, in the latter part of the year, an improvement in equity markets drove a recovery in our investment-related fee income. In India, tightened credit criteria resulted in lower fees from the card business. By contrast, trade services and cash management increased in a number of countries, and we took various steps to capture cross-border business and continued to benefit from our international business reach. Significant cross-border referral growth was seen in Greater China where numbers rose compared with 2008.

Net trading income declined by 16%, as the fall in interest rates reduced net interest income from trading activities. Foreign exchange and Rates trading income also declined across the region, reflecting relatively low market volatility, though Credit trading performance was strong, particularly in mainland China, Japan and Singapore. In mainland China, the decline in Rates income resulted from losses on bond positions following an upward shift in yields. However, in South Korea, revenue increased as opportunities arose from market-making and client hedging activities.

Net income from *financial instruments designated at fair value* of US\$110m was recorded compared with a net expense of US\$171m in 2008. This was primarily attributable to equity market-related gains on unit-linked insurance products and was largely offset by a corresponding increase in liabilities to policyholders reflected in net insurance claims incurred and movement in liabilities to policyholders.

Net earned insurance premiums increased by 91% to US\$365m. Sales growth was particularly strong in Singapore following the launch of new products, including a life insurance product designed for high net worth individuals and a single premium guaranteed saver product. Growth in insurance business resulted in higher *net insurance claims incurred and movement in liabilities to policyholders*.

Loan impairment charges and other credit risk provisions rose by 9% compared with 2008 as credit quality deteriorated in India.

In PFS, loan impairment charges rose by 9% to US\$649m, primarily due to rising delinquencies in our unsecured consumer lending businesses in India and Indonesia. In India, a challenging credit environment and high delinquency rates contributed to increased loan impairment charges in personal loans, consumer finance and mortgages. The delinquencies in India began to moderate in the second half of 2009 as the measures we had implemented in the

second half of 2008 to mitigate loan losses, including ceasing consumer finance loan origination and tightening lending criteria on other unsecured lending products, began to take effect. As a result, loan impairment charges against cards remained broadly in line with 2008. In CMB, significant deterioration was experienced in India in the first half of 2009. The loan impairment charges across the region improved in the second half of 2009 with credit quality stabilising as a result of support from the governments' various economic stimulus initiatives, together with improved liquidity and actions taken by our customers to adjust in difficult times. Notwithstanding the improvement

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Report of the Directors: Operating and Financial Review (continued)

towards the end of the year, we continue to closely monitor portfolios for signs of weakness.

Operating expenditure was broadly in line with 2008. Tight cost control resulted in lower administrative costs and marketing expenditure. Staff costs fell due to lower performance-related costs and a decrease in staff numbers. These were broadly offset by expenditure to support the ongoing development of infrastructure in the region, including branch expansion in mainland China, Vietnam and Malaysia and integration and development costs related to HSBC InvestDirect and the operations of The Chinese Bank Co., Ltd (The Chinese Bank) in Taiwan.

In an effort to improve operational efficiencies and reduce costs, an increased number of transactions were completed through direct channels, including internet banking, telephone services and self-service machines compared with 2008.

Operating expenses within the Group Service and Software Development Centres rose by 9% as the number of migrated activities and processes increased in accordance with our global resourcing strategy to develop centres of excellence. All related costs are recharged to other Group entities and the income from these recharges is reported within *other operating income*.

Profit from associates and joint ventures in the region was 17% higher as a result of the non-recurrence of Ping An Insurance's impairment of its investment in Fortis in 2008, and an increase in new business sales and investment returns which were boosted by a recovery in equity markets. Income from Bank of Communications remained in line with 2008.

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Report of the Directors: Operating and Financial Review (continued)*Profit before tax and balance sheet data Rest of Asia-Pacific*

	Personal Financial Services US\$m	Commercial Banking US\$m	Global Banking & Markets US\$m	2010 Global Private Banking US\$m	Inter- segment Other elimination ⁵⁶ US\$m	US\$m	Total US\$m
<i>Profit before tax</i>							
Net interest income	1,581	938	1,435	91	55	(272)	3,828
Net fee income/(expense)	668	442	777	55	(10)		1,932
Trading income/(expense) excluding net interest income	81	129	966	69	(38)		1,207
Net interest income on trading activities			138		1	272	411
Net trading income/(expense) ⁴⁹	81	129	1,104	69	(37)	272	1,618
Changes in fair value of long-term debt issued and related derivatives					(2)		(2)
Net income/(expense) from other financial instruments designated at fair value	41	2	(1)		(16)		26
Net income/(expense) from financial instruments designated at fair value	41	2	(1)		(18)		24
Gains less losses from financial investments	1	3	50		92		146
Dividend income			1				1
Net earned insurance premiums	386	62					448

Other operating income	108	86	56	1	1,499	(152)	1,598
Total operating income	2,866	1,662	3,422	216	1,581	(152)	9,595
Net insurance claims ⁵⁷	(324)	(39)					(363)
Net operating income⁴⁶	2,542	1,623	3,422	216	1,581	(152)	9,232
Loan impairment charges and other credit risk provisions	(298)	(19)	(122)				(439)
Net operating income	2,244	1,604	3,300	216	1,581	(152)	8,793
Total operating expenses	(2,164)	(799)	(1,163)	(135)	(1,034)	152	(5,143)
Operating profit	80	805	2,137	81	547		3,650
Share of profit in associates and joint ventures	986	751	447		68		2,252
Profit before tax	1,066	1,556	2,584	81	615		5,902
	%	%	%	%	%		%
Share of HSBC's profit before tax	5.6	8.2	13.6	0.4	3.2		31.0
Cost efficiency ratio	85.1	49.2	34.0	62.5	65.4		55.7
<i>Balance sheet data⁴⁵</i>							
	US\$m	US\$m	US\$m	US\$m	US\$m		US\$m
Loans and advances to customers (net)	37,831	31,423	35,810	3,489	178		108,731
Total assets	49,508	41,588	166,960	12,126	19,450	(11,570)	278,062
Customer accounts	54,741	36,943	53,752	12,620	99		158,155

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Report of the Directors: Operating and Financial Review (continued)

Rest of Asia-Pacific	Personal		Global Banking & Markets US\$m	2009	Inter-		Total US\$m
	Financial Services US\$m	Commercial Banking US\$m		Global Private Banking US\$m	Other	segment elimination ⁵⁶ US\$m	
<i>Profit before tax</i>							
Net interest income	1,493	807	1,174	115	91	(141)	3,539
Net fee income/(expense)	554	331	636	55	(19)		1,557
Trading income/(expense) excluding net interest income	80	134	1,013	55	(18)		1,264
Net interest income/(expense) on trading activities	(1)		202			141	342
Net trading income/(expense) ⁴⁹	79	134	1,215	55	(18)	141	1,606
Changes in fair value of long-term debt issued and related derivatives					(1)		(1)
Net income/(expense) from other financial instruments designated at fair value	110	1	(2)		2		111
Net income/(expense) from financial instruments designated at fair value	110	1	(2)		1		110
Gains less losses from financial investments	5	2	(7)		(19)		(19)
Dividend income			1		1		2
	337	28					365

Net earned insurance premiums							
Other operating income/(expense)	67	66	41	(2)	1,200	(134)	1,238
Total operating income	2,645	1,369	3,058	223	1,237	(134)	8,398
Net insurance claims ⁵⁷	(380)	(15)					(395)
Net operating income ⁴⁶	2,265	1,354	3,058	223	1,237	(134)	8,003
Loan impairment charges and other credit risk provisions	(649)	(221)	(23)	(2)	(1)		(896)
Net operating income	1,616	1,133	3,035	221	1,236	(134)	7,107
Total operating expenses	(1,839)	(636)	(1,006)	(131)	(972)	134	(4,450)
Operating profit/(loss)	(223)	497	2,029	90	264		2,657
Share of profit in associates and joint ventures	686	567	290				1,543
Profit before tax	463	1,064	2,319	90	264		4,200
	%	%	%	%	%	%	
Share of HSBC's profit before tax	6.5	15.0	32.8	1.3	3.7		59.3
Cost efficiency ratio	81.2	47.0	32.9	58.7	78.6		55.6

*Balance sheet data*⁴⁵

	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m
Loans and advances to customers (net)	30,433	22,595	23,989	2,834	192	80,043
Total assets	40,266	31,221	138,884	11,928	7,160	222,139
Customer accounts	47,573	30,196	43,698	12,496	36	133,999

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)

Rest of Asia-Pacific	Personal		Global Banking & Markets US\$m	2008 Global		Inter- segment Other elimination ⁵⁶ US\$m	Total US\$m
	Financial Services US\$m	Commercial Banking US\$m		Private Banking US\$m			
<i>Profit before tax</i>							
Net interest income	1,708	934	1,524	103	139	(471)	3,937
Net fee income	592	356	831	71	17		1,867
Trading income/(expense) excluding net interest income	65	122	1,233	77	(54)		1,443
Net interest income/(expense) on trading activities	(5)		123		10	471	599
Net trading income/(expense) ⁴⁹	60	122	1,356	77	(44)	471	2,042
Changes in fair value of long-term debt issued and related derivatives					1		1
Net income/(expense) from other financial instruments designated at fair value	(172)		(4)		4		(172)
Net income/(expense) from financial instruments designated at fair value	(172)		(4)		5		(171)
Gains less losses from financial investments	15	3	6				24
Dividend income			2				2
	172	25					197

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Net earned insurance premiums							
Other operating income/ (expense)	58	76	79	(1)	1,070	(227)	1,055
Total operating income	2,433	1,516	3,794	250	1,187	(227)	8,953
Net insurance claims ⁵⁷	42	(14)					28
Net operating income ⁴⁶	2,475	1,502	3,794	250	1,187	(227)	8,981
Loan impairment charges and other credit risk provisions	(640)	(137)	(73)	(1)	(1)		(852)
Net operating income	1,835	1,365	3,721	249	1,186	(227)	8,129
Total operating expenses	(2,016)	(689)	(1,086)	(140)	(1,000)	227	(4,704)
Operating profit/(loss)	(181)	676	2,635	109	186		3,425
Share of profit in associates and joint ventures	392	559	335		11		1,297
Profit before tax	211	1,235	2,970	109	197		4,722
	%	%	%	%	%		%
Share of HSBC's profit before tax	2.3	13.3	31.9	1.2	2.0		50.7
Cost efficiency ratio	81.5	45.9	28.6	56.0	84.2		52.4
<i>Balance sheet data</i> ⁴⁵							
	US\$m	US\$m	US\$m	US\$m	US\$m		US\$m
Loans and advances to customers (net)	27,634	21,967	27,941	2,960	159		80,661
Total assets	36,310	29,030	147,714	12,440	5,528	(5,449)	225,573
Customer accounts	42,778	25,372	42,977	12,713	354		124,194

For footnotes, see page 83.

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)**Middle East**

In the Middle East, the network of branches of HSBC Bank Middle East Limited, together with HSBC's subsidiaries and associates, gives us the widest coverage in the region. Our associate in Saudi Arabia, The Saudi British Bank (40% owned), is the Kingdom's fifth largest bank by total assets.

	2010 US\$m	2009 US\$m	2008 US\$m
Net interest income	1,367	1,485	1,556
Net fee income	677	625	691
Net trading income	370	394	402
Other income	(4)	90	19
Net operating income ⁴⁶	2,410	2,594	2,668
Impairment charges ⁴⁷	(627)	(1,334)	(279)
Net operating income	1,783	1,260	2,389
Total operating expenses	(1,078)	(1,001)	(959)
Operating profit	705	259	1,430
Income from associates ⁴⁸	187	196	316
Profit before tax	892	455	1,746
Cost efficiency ratio	44.7%	38.6%	35.9%
Year-end staff numbers	8,676	8,281	8,453

**Underlying pre-tax
profit doubled
Leading provider of
traditional trade services
in the UAE**

**PFS in the Middle East
returns to profitability**

For footnotes, see page 83.

The commentary on the Middle East is on an underlying basis unless stated otherwise.

Economic background

Economic activity in much of the Middle East showed signs of stabilising during 2010. A 30% year on year rise in average oil prices led to a marked strengthening of public finances in the Gulf states, allowing governments such as **Saudi Arabia** to boost public current and capital spending. The high and stable average oil prices also improved external account positions in the Gulf, leading to an increase in reserves and overall net foreign asset accumulation following the modest drawdowns in 2009.

As well as receiving support from rising public spending, non-oil goods and service exporters in the region also benefited from rising external demand, particularly from Asia. The **UAE** was a leading beneficiary, most notably in its transport and logistics sectors. Banking sector activity remained relatively subdued, with rates of credit growth flat or negative in real terms across much of the region. This contributed to subdued consumer and asset price inflation. Although there was some evidence in **Saudi Arabia, Oman** and **Kuwait** that stronger growth and higher commodity prices were putting pressure on prices in late 2010, the pace of increase remained below that seen in other emerging markets. Inflation was largely absent in the UAE.

Dubai had another challenging year in 2010, as it continued to struggle with high levels of debt, falling real estate prices and a stagnant credit market. Although no figures have been released, officials estimated in October that real GDP was likely to have grown by 2.3% in 2010, mostly from global trade as exports rose 35% in the year to the third quarter. The domestic economy was considerably weaker through most of the year although there were signs of an improvement by the year end.

In **Egypt**, GDP growth returned to 6% by the end of 2010, driven primarily by domestic demand. Egypt's structural economic strengths leave us positive on the medium-term outlook, although recent political turmoil might overshadow its near-term prospects.

Review of performance

Our operations in the Middle East reported pre-tax profits of US\$892m, an increase of US\$437m compared with 2009.

In October 2010, we completed the sale of our investment in the British Arab Commercial Bank, on which a loss of US\$42m was recorded. On an underlying basis and excluding this loss, pre-tax profits increased by US\$481m.

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)*Profit/(loss) before tax by country within customer groups and global businesses*

	Personal Financial Services US\$m	Commercial Banking US\$m	Global Banking & Markets US\$m	Global Private Banking US\$m	Other US\$m	Total US\$m
2010						
Egypt	38	82	77		(2)	195
Qatar	19	52	67			138
United Arab Emirates	17	186	121	1	(1)	324
Other	19	57	(19)			57
Middle East (excluding Saudi Arabia)	93	377	246	1	(3)	714
Saudi Arabia	7	107	71	(16)	9	178
	100	484	317	(15)	6	892
2009						
Egypt	18	51	97	58	224	
Qatar	10	60	66		136	
United Arab Emirates	(177)	(136)	307	(2)	(3)	
Other	3	(15)	(80)	(3)	(95)	
Middle East (excluding Saudi Arabia)	(146)	(40)	390	(2)	60	262
Saudi Arabia	20	61	77	8	27	193
	(126)	21	467	6	87	455
2008						
Egypt	16	68	90	49	223	
Qatar	23	33	57		113	
United Arab Emirates	133	330	388	4	6	861
Other	57	92	104	1	254	

Middle East (excluding Saudi Arabia)	229	523	639	4	56	1,451
Saudi Arabia	60	35	177		23	295
	289	558	816	4	79	1,746

Profits increased strongly in the second half of 2010 compared with the first half of the year, reflecting increased stability in the regional economy and growing momentum in several of the key markets.

The improvement in the credit environment and our risk management actions combined to contribute to significantly lower loan impairment charges and other credit risk provisions. The benefit was partly offset by lower revenues from the run-off of higher yielding unsecured loans, mainly in the UAE.

Our Premier and Advance customer base continued to grow in line with our strategy to build a sustainable wealth-driven, premium-based PFS business, with Premier attracting 35,000 net new customers in the year, of whom 19,000 were new to the Group. During 2010, we launched the Advance proposition across most of the region and the number of customers reached 152,000 at 31 December 2010. The opening of our 100th branch in Egypt is an example of initiatives to expand our regional presence.

In CMB, we continued to build on our competitive advantage in international connectivity. The increased opportunities to support business and trade flows between the region and the rest of the world, particularly mainland China and India, led to strong trade-related revenues and supported our market-leading position in this business. As a result, we gained market share in our key markets and received several awards for trade services including Leading Trade Services Bank in the Middle East and North Africa which was awarded by *Global Trade Review* for the fourth consecutive year.

As part of our continued support to local internationally-focused businesses, we fully allocated the pledged US\$100m fund to UAE SME customers engaged in international cross-border business.

In GB&M we continued to invest in the region to support existing and anticipated new business and we now have a fully functional dealing room in Abu Dhabi and a China desk in the UAE to support East-East business. We continued to be recognised as the dominant player in regional bond markets and won several awards, including Best Investment Bank in the Middle East awarded by *Euromoney*.

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)

Net interest income decreased by 8% as average lending balances declined in both PFS and CMB, the proportion of higher yielding assets fell and the cost of liquidity remained high.

In PFS, spreads narrowed as we focused new lending on Premier and Advance customers, while concurrently managing down higher risk unsecured lending balances, mostly in the UAE.

In CMB, asset balances and net interest income rose throughout the second half of 2010 as increasing trade finance balances contributed to growing revenues.

Average customer accounts declined as corporate customers reduced their deposits in response to tighter liquidity in the local markets. This was partly offset by an increase in average liability balances in PFS, which was driven by successful deposit campaigns launched in 2010 and by the acquisition of Premier and Advance customers. Our overall liquidity position improved although the market returns on the deployment of liquidity remained low.

Net fee income increased by 8%, primarily driven by higher volumes of credit facilities related to trade, guarantees and remittances in CMB. The benefit was partly offset by lower advisory revenues from equity capital markets in GB&M as a result of limited issuances in the regional equity markets.

Net trading income fell by 6% to US\$370m. Subdued trading conditions and the non-recurrence of gains which had resulted from the tightening of credit spreads on certain positions in early 2009 resulted in lower Credit trading income. Foreign exchange income decreased with the easing in market volatility as speculation regarding the unpegging of Gulf currencies from the US dollar receded.

Other operating income declined by US\$37m as gains arising in 2009 from the buy-back and extinguishment of own debt did not recur.

Loan impairment charges and other credit risk provisions decreased by 53%. An overall improvement in credit conditions in the region along with enhanced collections processes, improvements in the quality of our customer base and a reduction in unsecured lending resulted in significantly lower net collective impairment provisions, notably in the UAE, and lower requirements for specific corporate provisions.

In PFS, strengthened collections processes and a repositioning of the loan book contributed to lower delinquency rates. In CMB, loan impairment charges and other credit risk provisions decreased due to significantly lower net collectively assessed impairment charges and fewer specific loan impairment charges, with the majority of the charge in 2010 relating to a small number of large corporate customers.

Loan impairment charges and other credit risk provisions in GB&M rose, mainly from restructuring activity which drove UAE-related loan impairments for a small number of large corporate customers in the first half of 2010. The improvement in economic conditions during the latter part of 2010 resulted in lower loan impairment charges in the second half of the year.

Operating expenses increased by 8%, driven by increased investment in marketing and advertising, including key sponsorship deals and the promotion of the HSBC brand through strategic messaging in the Abu Dhabi and Dubai airports, together with an increase in premises and people costs, mainly from the investment in the branch network expansion in Egypt.

Profit from associates and joint ventures decreased by 5%. The contribution from The Saudi British Bank was lower as revenue fell in challenging operating conditions.

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)**2009 compared with 2008**

Economic background

Although the majority of economies in the **Middle East** were spared the most severe effects of the global recession, 2009 marked a dramatic downturn as growth slowed markedly, bringing a sharp end to a five-year run of strong expansion.

In part, the region proved vulnerable to weakened external demand, particularly economies such as Egypt and the UAE that are significant service and merchandise exporters to the West and are exposed to global trade patterns. A sharp drop in hydrocarbon prices in late 2008 and early 2009 adversely affected sentiment and caused some oil-exporters to reassess spending plans as their revenue streams weakened.

In addition, the liquidity environment tightened considerably during the course of the year. This led to a rapid slowdown in credit creation, weighing heavily on private consumption and investment spending and contributing to marked downward pressure on asset prices. Access to international funding was also impaired as global capital flows slowed, further impeding local investment spending.

The recovery of the region may lag behind that of some other emerging markets. However, in contrast to 1998 (the last occasion on which growth trends sharply reversed) policymakers in Saudi Arabia and elsewhere were able to draw on reserves built up during years of high oil earnings to maintain spending, rather than boosting borrowing. With the recovery in oil prices from mid-2009 onward, the reserves allowed the region to weather the difficult economic environment without experiencing pressure on external balances or a downturn in the dollar value of local currencies. Inflation also fell across the region as growth slowed and import prices fell, and policymakers were able to track the exceptionally low level of interest rates in the US.

Review of performance

Our operations in the Middle East reported a pre-tax profit of US\$0.5bn compared with US\$1.7bn in 2008, a decrease of 74% on both reported and underlying bases. The decline in profitability was largely due to the impact of the global recession, which brought a sharp decline in oil prices and a considerable reduction in capital inflows in the second half of 2008, triggering a regional economic downturn which continued throughout 2009. The UAE was significantly affected by declines in construction and global trade, losses incurred by regional investors, and tight liquidity and lower real-

estate prices, which together resulted in higher loan impairment charges as the crisis affected both personal and corporate customers. However, despite the severe deterioration in credit conditions, the region remained profitable due to GB&M. In PFS, we continued to focus on Premier and affluent mass market customers, growing our Premier customer base by 32% compared with 2008. We further expanded our presence in Egypt, opening 15 new branches in 2009.

Net interest income declined by 4%, driven by lower deposit and lending balances and deposit spread compression across all customer groups.

CMB lending balances fell as trade levels declined. In PFS, average mortgages and credit card balances were higher than in 2008, reflecting the deferred drawdown of facilities approved in 2008. Unsecured personal lending balances declined during the year due to tighter origination criteria and a move towards relationship lending. The shift in the composition of personal lending portfolios, from unsecured to secured lending, resulted in narrower asset spreads.

Customer deposit balances fell, mainly due to an outflow of funds from corporate customers reflecting tighter liquidity in the local markets. In PFS, liability balances rose due to the combination of attractive rates offered and ongoing marketing campaigns, although the higher rates resulted in narrower deposit spreads.

Net fee income fell by 9%, due to a decline in custody, insurance and unit trust income as investor sentiment weakened in the difficult market conditions and trade finance fees declined as regional trade deteriorated. Cards income also fell due to lower drawdowns and originations as underwriting criteria were tightened.

Trading income was broadly in line with 2008 as weaker foreign exchange and Rates trading revenue were offset by higher revenue from Credit trading on favourable positioning of the trading portfolio in expectation of spreads narrowing from their peak in the third quarter of 2008.

Other operating income rose by US\$62m, driven by gains arising from the buy-back and extinguishment of our own debt issued locally.

Loan impairment charges and other credit risk provisions rose significantly from US\$0.3bn to US\$1.3bn, reflecting substantially higher charges in the UAE where the deterioration in credit quality was particularly significant. The UAE's real estate and construction industries were adversely affected by the global economic crisis, resulting in several

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)

large infrastructure projects being postponed or cancelled, and triggering higher levels of unemployment. This resulted in increased delinquencies, notably in credit cards and personal loans, which were exacerbated by large numbers of expatriate workers departing the region leaving debts unpaid. We took steps to mitigate losses, including reducing our credit lines, tightening origination criteria and strengthening collections activities.

Commercial and corporate banking loan impairment charges rose sharply, primarily due to a few individually significant impairment charges recorded on exposures to large corporates.

Operating expenditure increased by 6%. Staff costs remained broadly flat as higher expenditure in GB&M was offset by lower staff costs in PFS and CMB as headcount declined. Non-staff costs rose as new headquarter buildings in the UAE and Qatar caused higher rental costs, and IT investment increased from systems upgrades and rollouts.

Profit from associates and joint ventures in the region fell by 38% as our share of income from The Saudi British Bank declined as a result of higher loan impairment charges. Our share of income from HSBC Saudi Arabia Ltd declined as a result of a slowdown in IPOs and a decline in assets under management.

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)*Profit/(loss) before tax and balance sheet data Middle East*

	Personal Financial Services US\$m	Commercial Banking US\$m	Global Banking & Markets US\$m	2010 Global Private Banking US\$m	Other elimination ⁵⁶ US\$m	Inter- segment US\$m	Total US\$m
<i>Profit/(loss) before tax</i>							
Net interest income	553	473	334		14	(7)	1,367
Net fee income	200	258	202	17			677
Trading income/(expense) excluding net interest income	59	85	205	1	(7)		343
Net interest income/(expense) on trading activities	1	7	18		(6)	7	27
Net trading income/(expense) ⁴⁹	60	92	223	1	(13)	7	370
Gains less losses from financial investments	1		(3)		(1)		(3)
Dividend income	2	1	4				7
Other operating income/(expense)	27	(8)	(1)	1	40	(67)	(8)
Total operating income	843	816	759	19	40	(67)	2,410
Net insurance claims ⁵⁷							
Net operating income ⁴⁶	843	816	759	19	40	(67)	2,410
Loan impairment charges and other credit risk provisions	(227)	(145)	(255)				(627)
Net operating income	616	671	504	19	40	(67)	1,783

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Total operating expenses	(524)	(297)	(263)	(18)	(43)	67	(1,078)
Operating profit/(loss)	92	374	241	1	(3)		705
Share of profit/(loss) in associates and joint ventures	8	110	76	(16)	9		187
Profit/(loss) before tax	100	484	317	(15)	6		892
	%	%	%	%	%		%
Share of HSBC's profit before tax	0.5	2.6	1.7	(0.1)			4.7
Cost efficiency ratio	62.2	36.4	34.7	94.7	107.5		44.7
<i>Balance sheet data</i> ⁴⁵							
	US\$m	US\$m	US\$m	US\$m	US\$m		US\$m
Loans and advances to customers (net)	5,063	12,293	7,247	21	2		24,626
Total assets	6,244	13,991	31,295	59	4,129	(2,961)	52,757
Customer accounts	17,538	10,319	5,306	290	58		33,511

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)

Middle East	Personal		Global	2009 Global	Inter-		Total
	Financial Services US\$m	Commercial Banking US\$m	Banking & Markets US\$m	Private Banking US\$m	Other US\$m	segment elimination ⁵⁶ US\$m	US\$m
<i>Profit/(loss) before tax</i>							
Net interest income	644	464	330	1	46		1,485
Net fee income	203	219	198	3	2		625
Trading income excluding net interest income	55	75	235	1	3		369
Net interest income on trading activities			20		5		25
Net trading income ⁴⁹	55	75	255	1	8		394
Gains less losses from financial investments	12	(2)	1		5		16
Dividend income			3				3
Other operating income/ (expense)	35	39	35	(1)	39	(76)	71
Total operating income	949	795	822	4	100	(76)	2,594
Net insurance claims ⁵⁷							
Net operating income ⁴⁶	949	795	822	4	100	(76)	2,594
Loan impairment charges and other credit risk provisions	(588)	(573)	(173)				(1,334)
Net operating income	361	222	649	4	100	(76)	1,260
Total operating expenses	(508)	(269)	(255)	(6)	(39)	76	(1,001)

Operating profit/(loss)	(147)	(47)	394	(2)	61		259
Share of profit in associates and joint ventures	21	68	73	8	26		196
Profit/(loss) before tax	(126)	21	467	6	87		455
	%	%	%	%	%		%
Share of HSBC's profit before tax	(1.8)	0.3	6.6	0.1	1.2		6.4
Cost efficiency ratio	53.5	33.8	31.0	150.0	39.0		38.6
<i>Balance sheet data</i> ⁴⁵							
	US\$m	US\$m	US\$m	US\$m	US\$m		US\$m
Loans and advances to customers (net)	5,979	10,281	6,554	28	2		22,844
Total assets	6,810	11,861	28,189	96	4,952	(3,801)	48,107
Customer accounts	15,074	10,122	5,752	1,172	409		32,529
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Report of the Directors: Operating and Financial Review (continued)

Middle East	Personal		Global	2008 Global	Inter-		Total
	Financial	Commercial	Banking	Private	Other	segment	
	Services	Banking	&	Banking	elimination ⁵⁶		US\$m
	US\$m	US\$m	Markets	US\$m	US\$m	US\$m	US\$m
			US\$m				
<i>Profit before tax</i>							
Net interest income	652	510	362	3	46	(17)	1,556
Net fee income	227	241	217	6			691
Trading income excluding net interest income	47	65	244		24		380
Net interest income/(expense) on trading activities			20		(15)	17	22
Net trading income ⁴⁹	47	65	264		9	17	402
Gains less losses from financial investments	14		(6)				8
Dividend income			2				2
Other operating income	21	8	11	3	26	(60)	9
Total operating income	961	824	850	12	81	(60)	2,668
Net insurance claims ⁵⁷							
Net operating income ⁴⁶	961	824	850	12	81	(60)	2,668
Loan impairment (charges)/ recoveries and other credit risk provisions	(223)	(45)	(12)		1		(279)
Net operating income	738	779	838	12	82	(60)	2,389

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Total operating expenses	(511)	(264)	(212)	(8)	(24)	60	(959)
Operating profit	227	515	626	4	58		1,430
Share of profit in associates and joint ventures	62	43	190		21		316
Profit before tax	289	558	816	4	79		1,746
	%	%	%	%	%		%
Share of HSBC's profit before tax	3.1	6.0	8.9		0.8		18.8
Cost efficiency ratio	53.2	32.0	24.9	66.7	29.6		35.9
<i>Balance sheet data</i> ⁴⁵							
	US\$m	US\$m	US\$m	US\$m	US\$m		US\$m
Loans and advances to customers (net)	7,226	13,221	6,649	29	170		27,295
Total assets	8,168	14,672	27,975	46	5,754	(5,663)	50,952
Customer accounts	13,753	10,978	7,628	1,762	1,044		35,165

For footnotes, see page 83.

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)**North America**

Our North American businesses are located in the US, Canada and Bermuda. Operations in the US are primarily conducted through HSBC Bank USA, N.A., which is concentrated in New York State, and HSBC Finance, a national consumer finance company based near Chicago. HSBC Markets (USA) Inc. is the intermediate holding company of, inter alia, HSBC Securities (USA) Inc. HSBC Bank Canada and HSBC Bank Bermuda operate in their respective countries.

	2010 US\$m	2009 US\$m	2008 US\$m
Net interest income	12,439	13,670	15,218
Net fee income	3,664	4,817	5,227
Net trading income/ (expense)	314	331	(3,135)
Other income/(expense)	630	(2,513)	3,869
Net operating income ⁴⁶	17,047	16,305	21,179
Impairment charges ⁴⁷	(8,295)	(15,664)	(16,795)
Net operating income	8,752	641	4,384
Total operating expenses	(8,322)	(8,391)	(19,923)
Operating profit/(loss)	430	(7,750)	(15,539)
Income from associates ⁴⁸	24	12	11
Profit/(loss) before tax	454	(7,738)	(15,528)
Cost efficiency ratio	48.8%	51.5%	94.1%
Year-end staff numbers	33,865	35,458	44,725

**Pre-tax profit for the
first time since 2006
Impairment charges at
lowest levels since 2006**

Card and Retail Services
pre-tax profit
US\$2.0bn

2009: US\$641m; 2008: US\$837m

For footnotes, see page 83.

The commentary on North America is on an underlying basis unless stated otherwise.

Economic background

The economic recession in the **US** officially ended in the middle of 2009 but, given its depth and duration, the subsequent recovery was disappointing. In 2010, GDP expanded by 2.9%. The initial stage of the recovery was helped by tax reductions and direct subsidies for home purchases, but the growth momentum faded as their impact waned. In addition, fiscal tightening by state and local governments intensified, leading to spending cutbacks and job cuts that adversely affected consumer confidence and the rate of growth of consumer spending. Unemployment fell from 10.0% in the fourth quarter of 2009 to 9.4% by the end of 2010. The annual rate of core inflation (excluding food and energy products) fell steadily during the year to 0.8% in December, the smallest rate of annual increase in the 50 year history of the series.

In the fourth quarter of 2010, the Federal Reserve launched a US\$600bn programme of large scale asset purchases to ease monetary conditions. Asset prices rebounded and consumer spending picked up sharply, helping to renew economic activity.

In the year ended November 2010, **Canadian** GDP rose by 3%, compared with a decline of 1.2% in the year to November 2009, driven by housing construction, consumer spending and inventory restocking. Employment growth in the first half of 2010 was strong and the unemployment rate fell to 7.6% in December 2010 from the high of 8.7% in 2009. CPI inflation remained close to the Bank of Canada's 2% target through much of 2010 but the recovery in economic activity prompted the central bank to begin normalising the policy rate from a low of 0.25% to 1% by October.

Review of performance

In North America, a reported profit before tax of US\$454m in 2010 compared with a loss of US\$7.7bn in 2009. On an underlying basis, the pre-tax profit of US\$246m compared with a pre-tax loss of US\$4.0bn. The improved performance was largely due to a marked decline in loan impairment charges in our Card and Retail Services business and run-off portfolios, partly offset by lower revenue reflecting a reduction in lending balances, the effects of the CARD Act (see page 19) and adverse fair value movements on non-qualifying hedges.

Our results in 2011 will continue to be affected in general terms by the strength of the US economy and the impact of proposed regulatory changes on

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)*Profit/(loss) before tax by country within customer groups and global businesses*

	Personal Financial Services US\$m	Commercial Banking US\$m	Global Banking & Markets US\$m	Global Private Banking US\$m	Other US\$m	Total US\$m
2010						
US	(2,306)	402	1,285	113	(39)	(545)
Canada	110	505	248		4	867
Bermuda	47	32	49	(3)	7	132
Other				1	(1)	
	(2,149)	939	1,582	111	(29)	454
2009						
US	(5,292)	158	505	(49)	(3,626)	(8,304)
Canada	17	347	159		(100)	423
Bermuda	49	37	47	(2)	10	141
Other		1	1	1	(1)	2
	(5,226)	543	712	(50)	(3,717)	(7,738)
2008						
US ⁶²	(17,364)	226	(2,899)	67	3,427	(16,543)
Canada	106	380	252	5	96	839
Bermuda	31	51	72	11	9	174
Other	(1)	1			2	2
	(17,228)	658	(2,575)	83	3,534	(15,528)

For footnote, see page 83.

our business and, specifically, by the extent to which unemployment rates improve and the recovery in the housing market is sustained.

In 2010, we continued to reposition our core businesses and we remained focused on managing down our run-off assets. In addition, we made progress with the changes required to conform with new regulatory frameworks and policies.

In our core PFS business, we continued to grow our Premier proposition, with customer numbers increasing by 37% to over 700,000, and we expanded our branch network, opening five new branches in the states of California, Maryland and Virginia. Our Card and Retail Services business continued to be profitable, despite a decline in lending balances as customers reduced their outstanding credit card debt.

In CMB, we increased pre-tax profits by 51% to US\$873m as credit quality improved and we grew our revenue through repricing. In line with our global strategy to be the leading international business bank, CMB actively targeted the growing number of companies with international banking requirements achieving a 28% increase in referral volumes to other HSBC sites, and GB&M drove cross-regional and cross-customer group connectivity. GB&M and GPB also continued to appeal to internationally focused customers, attracted by the Group's presence in both emerging and developed markets.

Net interest income fell by 10% to US\$12.4bn as customer lending balances declined, mainly in HSBC Finance, due to the run-off of the residual balances in our Mortgage Services, Consumer Lending and vehicle finance portfolios. We took additional steps during 2010 to accelerate this process, selling US\$1.0bn in vehicle finance loans in March and the remainder of the portfolio (US\$4.3bn) in August to the same purchaser. Lower balances in our Card and Retail Services business reflected a decline in active accounts, actions taken to mitigate risk and an increased focus by our customers on reducing their credit card debt.

Asset spreads in Mortgage Services and Consumer Lending widened, reflecting lower funding costs and higher yields resulting from lower levels of modified loans and delinquent balances. In our Card and Retail Services portfolio asset spreads also widened due to lower funding costs, re-pricing initiatives and contract re-negotiation with certain merchants, partly offset by the effects of the CARD Act.

Average customer deposit balances increased in PFS and CMB as we continued to grow our customer base. In GB&M, our increased deposit base reflected a rise in repurchase transactions. Deposit spreads improved, despite falling interest rates, mainly due to repricing as competitive pressures eased.

Lower net interest income from Balance Sheet Management reflected the sales and maturities of higher yielding assets and the reinvestment of the proceeds into lower yielding, lower risk assets.

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Net fee income fell by 25% to US\$3.7bn. Lower transaction volumes, a reduction in customer spending and customers actively seeking to reduce credit card debt improved delinquency trends, and the effects of changes required by the CARD Act led to lower late and overlimit fees in our Card and Retail Services business.

Net trading income of US\$314m was 8% lower than in 2009, primarily because of US\$353m adverse fair value movements in non-qualifying hedges due to the decrease in long-term US interest rates. This compared with US\$184m in favourable fair value movements on these instruments in 2009. The majority of these instruments were interest rate swaps used to economically hedge floating rate debt issued by HSBC Finance. The debt was issued to offset the increase in the duration of the company's mortgage portfolio resulting from lower prepayment rates and the corresponding rise in interest rate risk.

In 2010, we increased our estimates of exposure on repurchase obligations associated with loans previously sold, primarily to Government-sponsored enterprises (GSEs), which reduced our trading income by US\$341m compared with US\$65m in 2009. This related mainly to mortgages originated through broker channels. These trading losses were partly offset by a rise in GB&M, despite lower revenue from Rates, as write-backs on legacy positions in Credit trading compared with write-downs in 2009.

Net expense from financial instruments designated at fair value of US\$31m compared with net income of US\$192m in 2009. This was due to adverse fair value movements from interest rate ineffectiveness in the economic hedging of our long-term debt. In 2009, fair value movements on economic hedges resulted in net income.

Gains less losses from financial investments declined by 52% due to lower gains from asset sales in the available-for-sale portfolio, undertaken to reduce the overall level of balance sheet risk.

Net earned insurance premiums and *Net insurance claims incurred and movement in liabilities to policyholders* both declined. Lower premiums reflected a fall in sales of payment protection products following the discontinuance of mortgage originations in HSBC Finance. Claims and reserves declined as the lending balances and associated in-force insurance contracts reduced.

Other operating income declined by 70% to US\$167m as we recognised a loss of US\$207m on the sale of our vehicle finance loan portfolio and loan servicing platform. In addition, gains in 2009 from the sale of residential mortgages and the refinement of the income recognition methodology of long-term insurance contracts did not recur. This was partly offset by a gain on the sale of our New York headquarters building in 2010.

Loan impairment charges and other credit risk provisions decreased by 47% to US\$8.3bn, the lowest level since 2006. Although most significant in PFS, the decline was across all businesses as the economy generally improved in 2010.

Loan impairment charges in Card and Retail Services declined by 57%, reflecting lower lending balances and an increased focus by our customers on reducing outstanding credit card debt. There was also an overall improvement in the credit quality of the portfolio, with lower delinquency levels and better delinquency roll rates.

Loan impairment charges in our Mortgage Services and Consumer Lending businesses fell by 29% as balances continued to run-off and delinquent balances reduced. Loss severity also improved reflecting an increase in deed-in-lieu and short sales agreements, both of which result in lower losses than foreclosed loans.

As a result of investigations into the foreclosure practices of certain mortgage service providers, there could be additional delays in the processing of foreclosures. See page 83 for more information.

In GB&M, a net release of loan impairment charges and other credit risk provisions of US\$184m compared with a reported net charge of US\$621m in 2009. This reflected an improvement in the credit environment and a release of impairments on available-for-sale ABSs. In CMB, loan impairment charges declined as the improved economic conditions resulted in credit upgrades on certain accounts and fewer downgrades across all business lines. Further

commentary on delinquency trends in the US PFS portfolios is provided on page 110.

Operating expenses fell by 2% to US\$8.3bn, reflecting the non-recurrence of restructuring costs following the closure of the Consumer Lending branch network in 2009 and the reduced scope of our business operations in the US as we ran off the legacy portfolios in HSBC Finance. In addition, we recorded a pension curtailment gain in 2010 and deposit insurance costs declined as a 2009 special assessment did not recur. These reductions were partly offset by a rise in marketing expenses in Card and Retail Services, an increase in litigation provisions and higher regulatory and compliance costs.

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Report of the Directors: Operating and Financial Review (continued)**2009 compared with 2008**

Economic background

Economic conditions remained extremely difficult in the US during the early months of 2009 before some signs of recovery appeared as the year progressed, limiting the decline in full year GDP to 2.4% after a 0.4% increase during 2008. Housing sales and residential construction activity showed some improvement from very depressed levels and this, along with the introduction of tax incentives, drove a reduction in the rate of decline of house prices in some states as the year progressed. Labour market conditions weakened throughout the year as the unemployment rate rose to a 26-year high of 10.1% in October 2009, contributing to concerns around the trend of delinquencies on both secured and unsecured debt within the household sector. The annual CPI rate remained negative during the second and third quarters of the year before rising to 2.7% by December 2009, although this trend was largely reflective of the earlier volatility of energy prices. Measures of consumer confidence improved during the year, but remained consistent with a weak overall level of household expenditure. The Standard & Poor's S&P 500 stock market index recovered from a weak start to 2009 to eventually record a gain of 23% in the year. Having already lowered the Fed funds target rate to within a narrow range of between zero and 25 basis points, the Federal Reserve maintained their efforts to improve the availability of credit across the economy by purchasing a range of financial instruments, while a substantial fiscal stimulus package provided additional support to economic activity from the middle of the year.

Canadian GDP fell by 3.2% during the first eleven months of 2009 compared with the equivalent period of 2008, led by a sharp contraction of output within the manufacturing sector. Labour market conditions deteriorated as the unemployment rate rose from a level of 6.8% in December 2008 to an 11 year high of 8.7% in August 2009, before then declining slightly in the final months of the year. In common with many other economies, the headline CPI rate turned negative around the middle of 2009, largely reflecting the trend of energy prices, and the core rate of inflation displayed a more pronounced downward trend as 2009 progressed. Responding to this deteriorating economic outlook, the Bank of Canada cut its overnight interest rate from 1.5% in December 2008 to 0.25% in April 2009, and provided a conditional commitment to maintain this level of interest rates until the end of the second quarter of 2010.

Review of performance

In North America, we reported a loss before tax of US\$7.7bn in 2009 compared with a loss of US\$15.5bn in 2008. On an underlying basis, excluding US\$3.7bn of fair value movements on our own debt, and also excluding an impairment charge of US\$10.6bn in 2008 to fully write-off goodwill in respect of North America PFS, the pre-tax loss fell by 52% to US\$4.1bn. This improved performance was largely due to a marked reduction in write-downs and losses in GB&M, lower loan impairment charges in PFS and lower operating expenses following the closure of our Consumer Lending branch network at the beginning of 2009, partly offset by higher loan impairment charges and other credit risk provisions in the corporate and commercial, and GPB, books.

Net interest income in 2009 declined by 10%, mainly reflecting reduced asset balances in the legacy consumer finance portfolios, increases in average delinquencies and modified loans (which generate lower yields), the compression of deposit spreads and lower revenue from Balance Sheet Management activities. These effects were partly offset by lower funding costs from the decline in interest rates and higher credit card yields which were driven by the effects of re-pricing initiatives, interest rate floors and lower levels of promotional balances.

Loans and advances to customers declined, mainly in HSBC Finance, following decisions taken to cease new originations and run off the residual balances in Mortgage Services, Consumer Lending and vehicle finance. HSBC Bank USA sold US\$4.5bn of prime mortgages in 2009 in addition to normal sale activity. In our Card and Retail Services, balances declined due to lower consumer spending and steps taken by management to mitigate risk and reduce originations, including tightening initial credit-line sales authorisation criteria, closing inactive accounts, decreasing credit lines, restricting underwriting criteria, restricting cash access and reducing marketing expenditure. In

the second half of the year, we resumed direct marketing mailings and new customer account originations for portions of the sub-prime credit card portfolio which had held up well through the economic downturn.

In November 2009, we entered into an agreement to sell the vehicle finance loan servicing operation and US\$1.0bn of associated loans. This transaction is expected to close in the first quarter of 2010.

In December 2009, HSBC Finance revised the write-off period for its real estate secured and other

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Report of the Directors: Operating and Financial Review (continued)

personal lending portfolios in order to reflect changed customer behaviour, aligning it with the policy used across the Group. As a consequence of this, real estate secured loan balances are now written down to net realisable value generally no later than the end of the month in which the account becomes 180 days delinquent, and personal lending products balances are now written off no later than the end of the month in which the account becomes 180 days delinquent. This change did not have a material effect on our financial results as write-offs were offset with releases of related impairment allowances. However, the write-offs resulted in a US\$3.3bn reduction in gross balances in Mortgage Services and Consumer Lending.

Asset spreads narrowed slightly in the Mortgage Services and Consumer Lending portfolios as the effect of credit quality deterioration and increased loan modifications were partly offset by lower funding costs. Vehicle finance spreads widened due to lower funding costs. In Card and Retail Services, spreads widened due to lower funding costs, repricing initiatives, lower levels of promotional balances and interest rate floors on portions of the portfolio. In GB&M and CMB, asset spreads widened, primarily due to loan repricing and lower funding costs.

Customer deposit balances were broadly unchanged. In GB&M, reduced deposits reflected the decline in assets being funded. This reduction was partly offset in both PFS and CMB, which were successful in increasing deposits through Premier, the expanded branch network and various internet-based propositions. Liability spreads tightened as base rates declined, although spreads widened in the second half of 2009 as rates paid to customers decreased in line with major competitors.

Net interest income from Balance Sheet Management fell, despite strong performance in the first half of the year, affected by risk management initiatives which included selling higher yielding assets and reinvesting the proceeds in assets with a reduced risk profile, resulting in lower yield.

Net fee income declined by 7% to US\$4.8bn, driven by lower late, overlimit, interchange and cash advance fees in the US credit cards business. This was mainly due to a reduction in our cards in issue, lower transaction volumes and changes in customer behaviour. Fee income from enhancement services also decreased due to lower balances and fewer accounts, and the discontinuance of all but one partner relationship and a change in product mix to lower revenue products led to a decline in fee income from Taxpayer Financial Services. In GB&M, fee income from underwriting increased, driven by higher debt origination volumes.

Net trading income of US\$331m compared with a net trading loss of US\$3.1bn in 2008, primarily due to significantly lower write-downs on exposures in GB&M, as the effect of downgrades of monoline insurers and mortgage-backed securities were far less marked than in 2008. Revenue from foreign exchange fell, following a record performance in 2008 in which there had been unprecedented levels of market volatility and wider spreads. In Global Banking, fair value losses were recorded on certain credit default swap transactions used to hedge corporate loan exposures following the tightening of credit spreads, compared with gains in 2008.

Net income from financial instruments designated at fair value declined by 35% to US\$192m, as income from ineffective interest rate hedges related to long-term debt issued by our subsidiaries in North America reduced.

Gains less losses from financial investments were US\$296m, compared with a net loss of US\$123m in 2008. Gains in the current year were largely attributable to the sale of mortgage-backed securities, compared with losses on the sale of US government agency securities in 2008. Gains from the sale of Visa shares in 2008 did not recur.

Net earned insurance premiums declined by 21% as lower loan balances and the discontinuation of real estate originations in HSBC Finance led to lower premiums from payment protection insurance products.

Other operating income was US\$566m compared with US\$26m in 2008 due to lower losses on sales of repossessed properties during 2009. House prices began to stabilise during the second half of the year and this resulted in less deterioration in value in the time between taking title and selling the property. Also, there were further delays in the foreclosure process in 2009, resulting in lower inventory levels and fewer sales. In addition, HSBC Finance

recognised gains from the refinement of the income recognition methodology of long-term insurance contracts, and gains on the sale of prime mortgages in HSBC Bank USA increased.

Net insurance claims incurred and movements in liabilities to policyholders increased marginally to US\$241m as higher claims and an increase in liabilities for credit protection policies written against the US prime mortgage book were largely offset by reduced life insurance and disability claims due to a decline in the number of policies underwritten.

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Loan impairment charges and other credit risk provisions decreased by 7% to US\$15.7bn. Lower loan impairment charges in HSBC Finance were partly offset by increases in loan impairment charges and other credit risk provisions in GB&M, CMB, the US prime mortgage book and GPB.

Loan impairment charges in US consumer finance decreased by 12% to US\$13.5bn, due to a stabilisation in delinquency trends. In our Mortgage Services portfolio, loan impairment charges fell by 40% to US\$2.1bn as the portfolio progressed further into run-off. By contrast, there was a 4% rise in loan impairment charges in Consumer Lending, primarily in the unsecured portfolio due to a deterioration in the 2006 and 2007 vintages and, to a lesser extent, first lien real estate secured loans. This was partly offset by lower loan impairment charges for second lien real estate secured loans, reflecting a reduction in portfolio risk factors as delinquency trends stabilised and the outlook for current inherent losses on certain first lien real estate secured vintages improved. The change in write-off period referred above had no significant effect on loan impairment charges.

In Card and Retail Services, loan impairment charges decreased by 4%, due to lower loan balances, reflecting lower consumer spending and actions taken to manage risk, and stable credit conditions. In addition, the outlook for future loss estimates improved: the effect of higher unemployment on losses was not as severe as had been predicted, in part due to tighter underwriting; fuel prices declined; and government stimulus activities helped household cashflow. These developments occurred despite the continued deterioration of the US economy and higher levels of unemployment and personal bankruptcy filings.

In PFS in HSBC Bank USA, loan impairment charges rose by 18% to US\$616m, mainly in the prime residential mortgage portfolios. Higher delinquencies and losses were experienced due to credit quality deterioration and continued weakness in house prices in certain markets.

Loan impairment charges and other credit risk provisions in GB&M rose from US\$198m to US\$621m, driven by deterioration in the credit position of certain corporate clients and additional impairments recognised in respect of certain ABSs held in the available-for-sale portfolio which reflected mark-to-market losses. In CMB, loan impairment charges rose by 15% to US\$519m as the recession adversely affected the commercial real estate and construction portfolios in the US, and the commercial real estate, manufacturing, trade and service sectors in Canada. In GPB, higher loan impairment charges were attributable to a single specific charge.

Further commentary on delinquency trends in our US PFS portfolios is provided in *Areas of special interest personal lending* on page 106.

Operating expenses declined to US\$8.4bn. Apart from the non-recurrence of a US\$10.6bn charge for the impairment of the goodwill of the North American PFS business, savings from the decision to discontinue originations and close branches in the Consumer Lending business and other cost reduction initiatives drove expense reduction. Restructuring costs associated with the closure of our branch network amounted to US\$150m. Staff costs decreased as a result of lower staff numbers, offsetting higher performance-related costs in GB&M. General and administrative costs declined with lower marketing costs in Card and Retail Services as a significant element as origination activity was curtailed. Deposit insurance expenses increased by US\$143m following a Federal Deposit Insurance Corporation special assessment in response to the bail out of a number of regional banks.

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Report of the Directors: Operating and Financial Review (continued)*Profit/(loss) before tax and balance sheet data North America*

	Personal Financial Services US\$m	Commercial Banking US\$m	Global Banking & Markets US\$m	2010 Global Private Banking US\$m	Other US\$m	Inter- segment elimination ⁵⁶ US\$m	Total US\$m
<i>Profit/(loss) before tax</i>							
Net interest income/(expense)	9,912	1,525	952	190	(71)	(69)	12,439
Net fee income/(expense)	2,032	534	955	149	(6)		3,664
Trading income/(expense) excluding net interest income	(472)	17	563	13	(12)		109
Net interest income on trading activities	24	2	93		17	69	205
Net trading income/(expense) ⁴⁹	(448)	19	656	13	5	69	314
Changes in fair value of long- term debt issued and related derivatives					111		111
Net income/(expense) from other financial instruments designated at fair value	6		(2)		(4)		
Net income/(expense) from financial instruments designated at fair value	6		(2)		107		111
Gains less losses from financial investments	5	(6)	141		3		143
Dividend income	18	7	12	3	2		42
Net earned insurance premiums	245						245
Other operating income	(243)	242	64	15	2,351	(2,196)	233
Total operating income	11,527	2,321	2,778	370	2,391	(2,196)	17,191
Net insurance claims ⁵⁷	(148)				4		(144)
Net operating income⁴⁶	11,379	2,321	2,778	370	2,395	(2,196)	17,047

Loan impairment (charges)/recoveries and other credit risk provisions	(8,194)	(323)	184	38			(8,295)
Net operating income	3,185	1,998	2,962	408	2,395	(2,196)	8,752
Total operating expenses	(5,338)	(1,081)	(1,380)	(297)	(2,422)	2,196	(8,322)
Operating profit/(loss)	(2,153)	917	1,582	111	(27)		430
Share of profit/(loss) in associates and joint ventures	4	22			(2)		24
Profit/(loss) before tax	(2,149)	939	1,582	111	(29)		454
	%	%	%	%	%		%
Share of HSBC's profit before tax	(11.3)	5.0	8.3	0.6	(0.2)		2.4
Cost efficiency ratio	46.9	46.6	49.7	80.3	101.1		48.8
<i>Balance sheet data</i> ⁴⁵							
	US\$m	US\$m	US\$m	US\$m	US\$m		US\$m
Loans and advances to customers (net)	131,194	30,277	24,338	4,723			190,532
Total assets	154,086	39,213	306,416	5,824	9,373	(22,425)	492,487
Customer accounts	76,817	46,425	22,324	12,812	108		158,486

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Report of the Directors: Operating and Financial Review (continued)

North America	Personal Financial Services US\$m	Commercial Banking US\$m	Global Banking & Markets US\$m	2009 Global Private Banking US\$m	Other US\$m	Inter- segment elimination ⁵⁶ US\$m	Total US\$m
<i>Profit/(loss) before tax</i>							
Net interest income/(expense)	11,244	1,391	999	178	(84)	(58)	13,670
Net fee income	3,174	453	1,045	142	3		4,817
Trading income/(expense) excluding net interest income	257	(10)	(179)	(3)	(30)		35
Net interest income/(expense) on trading activities	60	3	175	(1)	1	58	296
Net trading income/(expense) ⁴⁹	317	(7)	(4)	(4)	(29)	58	331
Changes in fair value of long- term debt issued and related derivatives					(3,497)		(3,497)
Net income from other financial instruments designated at fair value					1		1
Net expense from financial instruments designated at fair value					(3,496)		(3,496)
Gains less losses from financial investments	16	3	277				296
Dividend income	21	5	27	2	(2)		53
Net earned insurance premiums	309						309
Other operating income	9	162	317	11	1,828	(1,761)	566
Total operating income/(expense)	15,090	2,007	2,661	329	(1,780)	(1,761)	16,546
Net insurance claims ⁵⁷	(241)						(241)
Net operating income/(expense) ⁴⁶	14,849	2,007	2,661	329	(1,780)	(1,761)	16,305
	(14,424)	(519)	(621)	(98)	(2)		(15,664)

Loan impairment charges and other credit risk provisions

Net operating income/(expense)	425	1,488	2,040	231	(1,782)	(1,761)	641
Total operating expenses	(5,651)	(958)	(1,328)	(281)	(1,934)	1,761	(8,391)
Operating profit/(loss)	(5,226)	530	712	(50)	(3,716)		(7,750)
Share of profit/(loss) in associates and joint ventures		13			(1)		12
Profit/(loss) before tax	(5,226)	543	712	(50)	(3,717)		(7,738)
	%	%	%	%	%		%
Share of HSBC's profit before tax	(73.8)	7.7	10.1	(0.7)	(52.6)		(109.3)
Cost efficiency ratio	38.1	47.7	49.9	85.4	(108.7)		51.5
<i>Balance sheet data</i> ⁴⁵							
	US\$m	US\$m	US\$m	US\$m	US\$m		US\$m
Loans and advances to customers (net)	151,671	31,292	18,654	5,236			206,853
Total assets	179,597	38,232	260,131	6,572	2,071	(11,589)	475,014
Customer accounts	74,228	42,900	19,095	12,834	100		149,157

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Report of the Directors: Operating and Financial Review (continued)

North America	Personal Financial Services US\$m	Commercial Banking US\$m	Global Banking & Markets US\$m	2008 Global Private Banking US\$m	Other US\$m	Inter- segment elimination ⁵⁶ US\$m	Total US\$m
<i>Profit/(loss) before tax</i>							
Net interest income	12,632	1,480	1,064	224	22	(204)	15,218
Net fee income/(expense)	3,896	391	818	181	(59)		5,227
Trading income/(expense) excluding net interest income	(250)	5	(3,516)	10	(128)		(3,879)
Net interest income/(expense) on trading activities	66		584		(110)	204	744
Net trading income/(expense) ⁴⁹	(184)	5	(2,932)	10	(238)	204	(3,135)
Changes in fair value of long-term debt issued and related derivatives					3,736		3,736
Net income/(expense) from other financial instruments designated at fair value	(2)		(1)		4		1
Net income/(expense) from financial instruments designated at fair value	(2)		(1)		3,740		3,737
Gains less losses from financial investments	65	5	(209)		19		(120)
Dividend income	36	11	27	3			77
Net earned insurance premiums	390						390
Other operating income/(expense)	(426)	140	240	20	1,419	(1,370)	23
Total operating income/(expense)	16,407	2,032	(993)	438	4,903	(1,370)	21,417
Net insurance claims ⁵⁷	(238)						(238)
Net operating income/(expense) ⁴⁶	16,169	2,032	(993)	438	4,903	(1,370)	21,179
	(16,132)	(449)	(198)	(16)			(16,795)

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Loan impairment charges and other credit risk provisions

Net operating income/(expense)	37	1,583	(1,191)	422	4,903	(1,370)	4,384
Operating expenses (excluding goodwill impairment)	(6,701)	(937)	(1,384)	(339)	(1,368)	1,370	(9,359)
Goodwill impairment	(10,564)						(10,564)
Operating profit/(loss)	(17,228)	646	(2,575)	83	3,535		(15,539)
Share of profit/(loss) in associates and joint ventures		12			(1)		11
Profit/(loss) before tax	(17,228)	658	(2,575)	83	3,534		(15,528)
	%	%	%	%	%		%
Share of HSBC's profit before tax	(185.1)	7.1	(27.7)	0.9	38.0		(166.8)
Cost efficiency ratio	106.8	46.1	(139.4)	77.4	27.9		94.1
<i>Balance sheet data</i> ⁴⁵							
	US\$m	US\$m	US\$m	US\$m	US\$m		US\$m
Loans and advances to customers (net)	179,663	35,725	35,583	5,243			256,214
Total assets	205,722	42,211	348,347	7,054	3,323	(10,355)	596,302
Customer accounts	65,830	39,105	23,844	14,657	96		143,532

For footnotes, see page 83.

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Report of the Directors: Operating and Financial Review (continued)**Latin America**

Our operations in Latin America principally comprise HSBC Bank Brasil S.A.-Banco Múltiplo, HSBC México, S.A., HSBC Bank Argentina S.A. and HSBC Bank (Panama) S.A. In addition to banking services, we operate insurance businesses in Brazil, Mexico, Argentina, Panama and a range of smaller markets.

	2010 US\$m	2009 US\$m	2008 US\$m
Net interest income	6,311	5,573	6,458
Net fee income	1,749	1,729	2,167
Net trading income	733	848	701
Other income	938	874	1,187
Net operating income⁴⁶	9,731	9,024	10,513
Impairment charges ⁴⁷	(1,544)	(2,526)	(2,492)
Net operating income	8,187	6,498	8,021
Total operating expenses	(6,394)	(5,375)	(5,990)
Operating profit	1,793	1,123	2,031
Income from associates ⁴⁸	2	1	6
Profit before tax	1,795	1,124	2,037
Cost efficiency ratio	65.7%	59.6%	57.0%
Year-end staff numbers	56,044	54,288	58,559

**Higher pre-tax profits
driven by an improvement
in credit quality
Record pre-tax profits
in Brazil of over
US\$1bn**

**New sales desks established
to promote trade with
mainland China**

For footnotes, see page 83.

The commentary on Latin America is on an underlying basis unless stated otherwise.

Economic background

The **Brazilian** economy expanded at its fastest rate in three decades in 2010, with GDP growing 7.5% on an annual basis in the third quarter. Consumer demand played a major role supported by a rapid expansion of credit, which rose by 20.5% in 2010, and robust labour market conditions, as the unemployment rate fell to an all-time low of 5.3% in December. The growth of domestic demand led to a rapid rise in import growth and a widening of Brazil's current account deficit and contributed, along with a rise in food prices during the year, to an increase in CPI inflation to 5.9% in December compared with 4.3% at the end of 2009. The Central Bank tightened monetary policy by 2 percentage points between April and July 2010 and raised commercial banks' reserve requirements and capital adequacy ratios on certain consumer loans in December.

Mexico's economy continued to recover in 2010, and GDP rose by 5.5% in the year. Strong external demand was the main driver of the recovery, leading to robust growth in the production of Mexican manufactured goods. By contrast, domestic demand was lacklustre, reflecting high unemployment, restricted credit availability and low levels of consumer confidence. This weak domestic demand and the rise in the peso kept inflation subdued during 2010 and the Central Bank of Mexico maintained its policy rate at 4.5% throughout the year.

In **Argentina**, third quarter GDP was 7.5% higher than for the comparable period in 2009. This improvement was led by a strong rebound in industrial production, which expanded by 12.7% in the year to November 2010. The manufacture of motor vehicles recovered particularly strongly, rising by 35% during the year, with many being exported to Brazil. Inflation remained high, in part due to rapid growth in the price of food and beverages.

Review of performance

Our operations in Latin America reported pre-tax profits of US\$1.8bn compared with US\$1.1bn in 2009, largely reflecting the strong performance in Brazil, which recorded pre-tax profits in excess of US\$1bn for the first time. On an underlying basis, pre-tax profits increased by 49% as loan impairment charges declined, reflecting better economic conditions and actions taken to improve asset quality by managing down riskier portfolios and enhancing risk management processes. Revenue was marginally lower as trading income declined from the strong performance recorded in 2009 and fee income fell

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Report of the Directors: Operating and Financial Review (continued)*Profit/(loss) before tax by country within customer groups and global businesses*

	Personal Financial Services US\$m	Commercial Banking US\$m	Global Banking & Markets US\$m	Global Private Banking US\$m	Other US\$m	Total US\$m
2010						
Argentina	88	90	106			284
Brazil	93	382	488	6	64	1,033
Mexico	165	24	219	4	(11)	401
Panama	48	57	33	2		140
Other	(100)	1	51	(2)	(13)	(63)
	294	554	897	10	40	1,795
2009						
Argentina	24	86	122			232
Brazil	(224)	211	515	5	3	510
Mexico	(31)	66	230	7		272
Panama	69	55	24			148
Other	(54)	(19)	40	(1)	(4)	(38)
	(216)	399	931	11	(1)	1,124
2008						
Argentina		111	113			224
Brazil	250	348	298	8	6	910
Mexico	360	157	190	7		714
Panama	51	37	33			121
Other	7	53	7	1		68
	668	706	641	16	6	2,037

due to reduced transaction volumes, although this was largely offset by increased income from Balance Sheet Management.

In PFS, spreads tightened in Mexico as lending was refocused from higher-yielding consumer loans to higher quality assets. The managing down of certain portfolios in Brazil and Mexico and the strengthening of underwriting and collections processes resulted in an overall increase in pre-tax profit in PFS. Across the region we continued to focus on new customer acquisition in the mass affluent market segment through our Premier and Advance

propositions. The number of Premier customers increased to over 790,000 at 31 December 2010. Advance was launched in Brazil, Mexico, Argentina, Panama and Chile in 2010 and customer numbers exceeded 425,000 at the end of the year. The insurance business continued to perform strongly, with revenue growing in Brazil, Mexico and Argentina due to the improving economic conditions.

The regional economic recovery and our focus on growing the CMB business drove increased domestic lending in our major markets. GB&M and CMB both benefited from our global connectivity by increasing intra-regional and inter-regional business, with GB&M in particular contributing to other regions and customer groups through increased cross-referrals. Our operations in Brazil and mainland China worked closely together on a number of initiatives, including the completion of the first renminbi-denominated trade settlement in the region. Dedicated sales desks were established in mainland China and Hong Kong to support our Latin America customers and promote trade with Brazil.

Net interest income increased by 4% to US\$6.3bn. Increased volumes of financial investments, a decline in the cost of funding trading positions as market interest rates fell and a change in the portfolio mix to higher-yielding longer-term assets drove a rise in revenue from Balance Sheet Management.

Average customer lending balances fell in PFS, as certain portfolios were managed down, notably in credit cards in Mexico and other higher-risk personal loan balances in Mexico and Brazil. However, year-end balances were higher than in 2009 as we reversed the decline in customer lending by selectively growing certain portfolios. Demand-driven lending increased in CMB and GB&M in Brazil and Argentina while, in Mexico, increased average lending balances in CMB were attributable to the continued strategy of targeting state and municipal customers.

Our operations in Brazil actively grew customer account balances to fund loan growth and meet higher liquidity requirements following regulatory

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Report of the Directors: Operating and Financial Review (continued)

changes. In Mexico and Argentina, sales and marketing initiatives supported by product and channel enhancements resulted in an increase in current and savings account balances. However, the benefit was partly offset by tighter spreads on customer accounts as a result of decreased market interest rates in Mexico and Argentina.

Fee income fell by 7% to US\$1.7bn, driven by lower transaction volumes in credit cards and account services in Mexico and reduced account services income in Brazil. Regulatory restrictions in Brazil and Mexico also reduced the fees that could be charged for certain banking services.

Net trading income of US\$733m was 23% lower than in 2009. A decline in market volatility which resulted in fewer trading opportunities meant that the strong performances in Foreign Exchange and Rates in 2009 were not repeated.

Net income on financial instruments designated at fair value declined by 21% to US\$425m, primarily due to lower investment returns experienced on assets held in support of the pension-linked portfolio in Brazil and annuity products in Argentina. An offsetting decrease was recorded in Net insurance claims incurred and movement in liabilities to policyholders.

Gains less losses from financial investments declined by US\$93m, largely because the gains on the sale of Visa Inc. shares in 2009 did not recur.

Net earned insurance premiums increased marginally to US\$2.1bn, driven by improved economic conditions which resulted in higher sales of policies in Brazil and Argentina through the branch network and a rise in premiums in Mexico. This, combined with repricing initiatives in Argentina and higher contributions in the pension-linked product in Brazil from PFS and CMB customers, resulted in increased premiums.

Net insurance claims incurred and movement in liabilities to policyholders of US\$1.8bn declined by 9%, mainly in pension-linked products in Brazil as lower investment gains were allocated to policyholders. This was partly offset by an increase related to higher premiums in Argentina and Mexico.

Loan impairment charges and other credit risk provisions declined by 44% in 2010 to US\$1.5bn. In PFS, the reduction in loan impairment charges reflected a significant decline in the size of the credit card portfolio in Mexico and an improvement in its quality as a result of repositioning the portfolio towards higher quality customers, tighter origination criteria and improved collection practices. Loan impairment charges also declined in Brazil, primarily in consumer finance portfolios including motor vehicle finance and payroll loans, as economic conditions improved and these portfolios were managed down. In CMB, loan impairment charges fell, largely in Brazil, as improved economic conditions and better credit quality resulted in lower specific impairment charges, while in Mexico loan impairment charges remained broadly unchanged.

Operating expenses increased by 10% to US\$6.4bn, driven largely by inflationary pressures and investment in infrastructure and technology projects across the region in support of improved operational efficiency and business growth. Staff costs increased in Brazil and Argentina due to union-agreed wage increases, although this was partly offset by a decline in average headcount as costs continued to be managed carefully. Non-staff expenditure also rose, driven mainly by higher marketing and advertising costs in Brazil as we positioned ourselves in this key growth market, and transactional taxes increased as sales grew.

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Report of the Directors: Operating and Financial Review (continued)**2009 compared with 2008**

Economic background

A mixture of weak external demand and the disruption caused by the H1N1 virus contributed to a substantial deterioration in economic conditions in **Mexico** during the first half of 2009. The period of recession ended decisively as the economy improved strongly during the third quarter of the year, but the previous sharp decline in activity had left GDP some 6.2% below the comparable figure in 2008. The annual CPI rate continued to moderate, falling from 6.5% in December 2008 to 3.6% in December 2009. In response to the deterioration in economic conditions, the Bank of Mexico cut its overnight interest rate by 375 basis points during the first seven months of 2009 to 4.5% by the end of the year.

The **Brazilian** economy experienced a mild contraction during the early months of 2009 but returned to growth during the second quarter of the year, helped by a recovery in household consumption and a broader stabilisation of external demand and commodity prices. Starting the year at unusually low levels, the unemployment rate increased during the early months of 2009 relative to the comparable period of 2008, before declining to the historically low level of 6.8% in December 2009. The annual CPI rate moderated from 5.9% in December 2008 to a level slightly below the central banks targeted rate of 4.5% at the year end. Faced with this softening of economic conditions and diminishing inflationary pressures, the central bank of Brazil reduced the policy Selic target rate by a cumulative 500 basis points during the first seven months of 2009, placing the rate at 8.75% at the end of the period.

In **Argentina**, economic activity was adversely affected by the decline in external demand during 2009, with a very weak level of growth being reported around the middle of the year. Industrial production is reported to have risen by 0.4% during 2009. The improving global and regional outlook during the second half of 2009 and a recovery in commodity prices provided some relief to the economy, enabling interest rates to ease.

Review of performance

Our operations in Latin America reported pre-tax profits of US\$1.1bn, compared with US\$2.0bn in 2008. On an underlying basis, pre-tax profits decreased by 33%, primarily attributable to significantly higher loan impairment charges in PFS and CMB and lower revenues in PFS. GB&M's performance improved driven by strong results in trading and Balance Sheet Management.

2009 was a year of consolidating risk policies and strongly emphasising cost control. We injected additional capital into Brazil and Mexico during the fourth quarter of 2009, in line with our strategy of focusing on emerging markets. In both Panama and Argentina, strong results were achieved in spite of the challenging economic environment. However, performance in Honduras, Costa Rica and El Salvador was significantly affected by higher loan impairment charges and lower income. One HSBC and Group systems were implemented in Chile and the operations in Panama were fully integrated.

Net interest income remained broadly in line with 2008 excluding the one-off interest income which arose on recovery of transactional taxes on insurance transactions in Brazil in 2008. Net interest income decreased in PFS as average customer lending volumes declined, primarily driven by actions taken to tighten credit criteria and manage down existing higher risk portfolios including credit cards, personal loans and vehicle finance. The effect was partly offset by higher income on increased lending to commercial customers, primarily in Brazil. Repricing initiatives taken during 2008 and early 2009 drove increased spreads on lending products.

Average customer deposit balances rose, resulting from an increase in commercial and Global Banking balances. In Mexico, PFS launched new deposit products to mitigate the fall in deposits. Deposit spreads narrowed due to falling interest rates, also primarily in Mexico.

Interest income rose in Balance Sheet Management, primarily in Brazil.

Net fee income declined by 8%. Tighter credit origination criteria resulted in lower credit card fees in Mexico. Account service fees also fell, primarily due to lower transaction volumes. Weak equity market performance in Brazil led to lower assets under management and related fee income. This was partly offset by growth in restructuring fees in GB&M.

Net trading income rose by 42% due to a strong performance in GB&M, particularly in the first half of the year in Brazil. This resulted from increased foreign exchange and Rates trading income, which benefited from early positioning against interest rate movements in a volatile market.

Net income from financial instruments designated at fair value rose by 36%, primarily from higher insurance-related assets. This resulted from

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Report of the Directors: Operating and Financial Review (continued)

business growth and a recovery of the Brazilian equity markets as well as an increase in the fair value of fixed income securities held in support of personal pension portfolios in the country. An offsetting increase was recorded in net insurance claims incurred and movement in liabilities to policyholders.

Net earned insurance premiums rose by 24%, driven by higher sales of pension and life assurance products. In addition, a number of customers in Brazil switched their personal pension annuities to HSBC. These gains were partially offset by the impact of the 2008 nationalisation of the pension system in Argentina on the annuities business there.

Net insurance claims incurred and movement in liabilities to policyholders rose, primarily as a result of the fair value movement on financial instruments referred to above and insurance business growth.

Other operating income fell by 29%, largely due to the non-recurrence of gains arising in 2008 on a refinement of the income recognition methodology used in respect of long-term insurance contracts in Brazil. In 2009, a one-off gain was realised on the sale of the head office in Argentina.

Loan impairment charges and other credit risk provisions rose by 15% as economic conditions deteriorated across the region. In the first half of 2009, our delinquencies rose as GDP fell and unemployment increased. The situation was exacerbated by the H1N1 virus in Mexico and the related economic shutdown. With the introduction of enhanced credit risk management techniques and gradual economic recovery, loan impairment charges in the second half of 2009 decreased by 11% compared with the second half of 2008 and by 27% on the first half of 2009.

In PFS, the combination of portfolio seasoning, which followed expansion in market share in previous years, and increased delinquencies in secured and unsecured personal lending products such as personal loans and payroll loans in Brazil and cards and mortgages in Mexico, resulted in higher loan impairment charges, mainly in the first half of 2009. Some payroll loan portfolios were run down in Brazil, as were several consumer finance and unsecured portfolios in Mexico. Loan impairment charges in PFS fell by 8% in the second half of the year compared with the same period in 2008 and by 27% compared with the first half of 2009.

Loan impairment charges rose in commercial lending portfolios, primarily in Business Banking and mid-market business segments in Brazil, as trade levels fell as a consequence of the global economic slowdown. This was partly offset by net releases in loan impairment charges in GB&M when compared with a net charge in 2008.

Operating expenses increased slightly by 2%, well below the inflation rates of the main economies in which we operate, reflecting significant cost control measures. The benefit from the reduction in staff numbers, which began in 2008 and continued in 2009, was partially offset by union-agreed pay rises. Savings in general and administrative costs were offset by investment expenditure on regional initiatives to centralise certain back office processes, and the implementation of One HSBC and Group systems intended to drive future operational efficiencies. Costs also increased in the form of higher litigation expenses and transactional taxes, the latter partly from the non-recurrence of a recovery of transactional taxes in the insurance business in 2008.

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Report of the Directors: Operating and Financial Review (continued)*Profit/(loss) before tax and balance sheet data Latin America*

	Personal Financial Services US\$m	Commercial Banking US\$m	Global Banking & Markets US\$m	2010 Global Private Banking US\$m	Other US\$m	Inter- segment elimination ⁵⁶ US\$m	Total US\$m
<i>Profit/(loss) before tax</i>							
Net interest income	3,975	1,671	776	20	121	(252)	6,311
Net fee income/(expense)	899	526	298	32	(6)		1,749
Trading income/(expense) excluding net interest income	35	72	370	3	(27)		453
Net interest income on trading activities			28			252	280
Net trading income/(expense) ⁴⁹	35	72	398	3	(27)	252	733
Changes in fair value of long-term debt issued and related derivatives							
Net income from other financial instruments designated at fair value	339	85	1				425
Net income from financial instruments designated at fair value	339	85	1				425
Gains less losses from financial investments	6	2	93		(3)		98

Dividend income	7	2	3				12
Net earned insurance premiums	1,651	374	29				2,054
Other operating income	90	34	23	2	221	(229)	141
Total operating income	7,002	2,766	1,621	57	306	(229)	11,523
Net insurance claims ⁵⁷	(1,479)	(297)	(16)				(1,792)
Net operating income⁴⁶	5,523	2,469	1,605	57	306	(229)	9,731
Loan impairment charges and other credit risk provisions	(1,247)	(293)	(4)				(1,544)
Net operating income	4,276	2,176	1,601	57	306	(229)	8,187
Total operating expenses	(3,983)	(1,623)	(704)	(47)	(266)	229	(6,394)
Operating profit	293	553	897	10	40		1,793
Share of profit in associates and joint ventures	1	1					2
Profit before tax	294	554	897	10	40		1,795
	%	%	%	%	%		%
Share of HSBC's profit before tax	1.5	2.9	4.7	0.1	0.2		9.4
Cost efficiency ratio	72.1	65.7	43.9	82.5	86.9		65.7
<i>Balance sheet data⁴⁵</i>							
	US\$m	US\$m	US\$m	US\$m	US\$m		US\$m
Loans and advances to customers (net)	20,823	24,879	12,242	43			57,987
Total assets	38,764	35,619	64,690	1,608	196	(939)	139,938
Customer accounts	30,149	24,514	27,810	6,053			88,526

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Report of the Directors: Operating and Financial Review (continued)

Latin America	Personal		Global Banking & Markets	2009 Global Private Banking	Other	Inter- segment elimination ⁵⁶	Total
	Financial Services US\$m	Commercial Banking US\$m	US\$m	US\$m	US\$m	US\$m	US\$m
<i>Profit/(loss) before tax</i>							
Net interest income/(expense)	3,736	1,544	590	19	(5)	(311)	5,573
Net fee income	948	490	251	28	12		1,729
Trading income excluding net interest income	25	38	573	3			639
Net interest income/(expense) on trading activities	4	2	(108)			311	209
Net trading income ⁴⁹	29	40	465	3		311	848
Changes in fair value of long-term debt issued and related derivatives Net income/(expense) from other financial instruments designated at fair value	510	12	(38)		11		495
Net income/(expense) from financial instruments designated at fair value	510	12	(38)		11		495
Gains less losses from financial investments	91		77				168
Dividend income	9	1	1				11
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Net earned insurance premiums	1,752	105	43				1,900
Other operating income/(expense)	170	35	24	2	(1)	(97)	133
Total operating income	7,245	2,227	1,413	52	17	(97)	10,857
Net insurance claims ⁵⁷	(1,750)	(58)	(25)				(1,833)
Net operating income ⁴⁶	5,495	2,169	1,388	52	17	(97)	9,024
Loan impairment (charges)/ recoveries and other credit risk provisions	(2,046)	(534)	57		(3)		(2,526)
Net operating income	3,449	1,635	1,445	52	14	(97)	6,498
Total operating expenses	(3,666)	(1,236)	(514)	(41)	(15)	97	(5,375)
Operating profit/(loss)	(217)	399	931	11	(1)		1,123
Share of profit in associates and joint ventures	1						1
Profit/(loss) before tax	(216)	399	931	11	(1)		1,124
	%	%	%	%	%		%
Share of HSBC's profit before tax	(3.1)	5.6	13.2	0.2			15.9
Cost efficiency ratio	66.7	57.0	37.0	78.8	88.2		59.6
<i>Balance sheet data</i> ⁴⁵							
	US\$m	US\$m	US\$m	US\$m	US\$m		US\$m
Loans and advances to customers (net)	19,748	18,205	9,645	31			47,629
Total assets	35,236	23,212	57,491	328	281	(581)	115,967
Customer accounts	30,628	19,775	20,142	2,344			72,889

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Report of the Directors: Operating and Financial Review (continued)

Latin America	Personal		Global Banking & Markets	2008 Global Private Banking	Other	Inter- segment elimination ⁵⁶	Total
	Financial Services US\$m	Commercial Banking US\$m	US\$m	US\$m	US\$m	US\$m	US\$m
<i>Profit before tax</i>							
Net interest income/(expense)	4,582	1,637	579	22	(35)	(327)	6,458
Net fee income	1,339	536	248	35	9		2,167
Trading income excluding net interest income	123	27	200	3	4		356
Net interest income/(expense) on trading activities	7	4	8		(2)	327	345
Net trading income ⁴⁹	130	31	208	3	2	327	701
Changes in fair value of long-term debt issued and related derivatives							
Net income from other financial instruments designated at fair value	187		139		38		364
Net income from financial instruments designated at fair value	187		139		38		364
Gains less losses from financial investments	132	21	21	2			176
Dividend income	16	1	3				20
Net earned insurance premiums	1,547	82	88				1,717
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Other operating income	244	57	39	3	8	(51)	300
Total operating income	8,177	2,365	1,325	65	22	(51)	11,903
Net insurance claims ⁵⁷	(1,281)	(42)	(68)		1		(1,390)
Net operating income ⁴⁶	6,896	2,323	1,257	65	23	(51)	10,513
Loan impairment charges and other credit risk provisions	(2,120)	(340)	(29)		(3)		(2,492)
Net operating income	4,776	1,983	1,228	65	20	(51)	8,021
Total operating expenses	(4,114)	(1,277)	(587)	(49)	(14)	51	(5,990)
Operating profit	662	706	641	16	6		2,031
Share of profit in associates and joint ventures	6						6
Profit before tax	668	706	641	16	6		2,037
	%	%	%	%	%		%
Share of HSBC's profit before tax	7.2	7.6	6.9	0.2			21.9
Cost efficiency ratio	59.7	55.0	46.7	75.4	60.9		57.0
<i>Balance sheet data</i> ⁴⁵							
	US\$m	US\$m	US\$m	US\$m	US\$m		US\$m
Loans and advances to customers (net)	18,523	15,460	8,273	31			42,287
Total assets	30,320	19,382	53,870	391	361	(1,378)	102,946
Customer accounts	27,564	14,367	15,384	2,128			59,443

For footnotes, see page 83.

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Report of the Directors: Operating and Financial Review (continued)**Reconciliation of reported and underlying profit/(loss) before tax****Europe***2010 compared with 2009*

	2009 as reported US\$m	2009 adjust- ments ⁹ US\$m	Currency translation ¹¹ US\$m	2009 at 2010 exchange rates ¹² US\$m	2010 as reported US\$m	2010 adjust- ments ¹⁰ US\$m	2010 under- lying US\$m	Re- ported change ¹³ %	Under- lying change ¹³ %
Net interest income	12,268	(1)	(189)	12,078	11,250		11,250	(8)	(7)
Net fee income	6,267	(210)	(125)	5,932	6,371		6,371	2	7
Changes in fair value ¹⁴	(2,841)	2,841			(198)	198		93	
Other income	7,850	(283)	(104)	7,463	5,327	(362)	4,965	(32)	(33)
Net operating income¹⁵	23,544	2,347	(418)	25,473	22,750	(164)	22,586	(3)	(11)
Loan impairment charges and other credit risk provisions	(5,568)		48	(5,520)	(3,020)		(3,020)	46	45
Net operating income	17,976	2,347	(370)	19,953	19,730	(164)	19,566	10	(2)
Operating expenses	(13,988)	200	220	(13,568)	(15,445)		(15,445)	(10)	(14)
Operating profit	3,988	2,547	(150)	6,385	4,285	(164)	4,121	7	(35)
Income from associates	21	(1)	(2)	18	17		17	(19)	(6)
Profit before tax	4,009	2,546	(152)	6,403	4,302	(164)	4,138	7	(35)

2009 compared with 2008

	2008 as reported US\$m	2008 adjust- ments ¹ US\$m	Currency translation ¹¹ US\$m	2008 at 2009 exchange rates ¹⁶ US\$m	2009 as reported US\$m	2009 adjust- ments ¹⁰ US\$m	2009 under- lying US\$m	Re- ported change ¹³ %	Under- lying change ¹³ %
Net interest income	9,696	(65)	(1,049)	8,582	12,268		12,268	27	43
Net fee income	7,492	(58)	(917)	6,517	6,267		6,267	(16)	(4)
Changes in fair value ¹⁴	3,118	(3,118)			(2,841)	2,841			
Gains on disposal of French regional banks	2,445	(2,445)						(100)	
Other income	7,928	(609)	(1,206)	6,113	7,850	(280)	7,570	(1)	24
Net operating income ¹⁵	30,679	(6,295)	(3,172)	21,212	23,544	2,561	26,105	(23)	23
Loan impairment charges and other credit risk provisions	(3,754)	6	395	(3,353)	(5,568)		(5,568)	(48)	(66)
Net operating income	26,925	(6,289)	(2,777)	17,859	17,976	2,561	20,537	(33)	15
Operating expenses	(16,072)	68	1,723	(14,281)	(13,988)		(13,988)	13	2
Operating profit	10,853	(6,221)	(1,054)	3,578	3,988	2,561	6,549	(63)	83
Income from associates	16			16	21		21	31	31
Profit before tax	10,869	(6,221)	(1,054)	3,594	4,009	2,561	6,570	(63)	83

For footnotes, see page 83.

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Report of the Directors: Operating and Financial Review (continued)**Hong Kong***2010 compared with 2009*

	2009 as reported US\$m	2009 adjust- ment US\$m	Currency translation ¹¹ US\$m	2009 at 2010 exchange rates ¹² US\$m	2010 as reported US\$m	2010 adjust- ments ¹⁰ US\$m	2010 under- lying US\$m	Re- ported change ¹³ %	Under- lying change ¹³ %
Net interest income	4,195		(7)	4,188	4,246		4,246	1	1
Net fee income	2,669		(4)	2,665	2,962		2,962	11	11
Changes in fair value ¹⁴	(1)	1			(6)	6		(500)	
Other income	2,604		(6)	2,598	3,000	(136)	2,864	15	10
Net operating income¹⁵	9,467	1	(17)	9,451	10,202	(130)	10,072	8	7
Loan impairment charges and other credit risk provisions	(500)		1	(499)	(114)		(114)	77	77
Net operating income	8,967	1	(16)	8,952	10,088	(130)	9,958	13	11
Operating expenses	(3,946)		6	(3,940)	(4,431)		(4,431)	(12)	(12)
Operating profit	5,021	1	(10)	5,012	5,657	(130)	5,527	13	10
Income from associates	8			8	35		35	338	338
Profit before tax	5,029	1	(10)	5,020	5,692	(130)	5,562	13	11

*2009 compared with
2008*

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	2008 as reported US\$m	2008 adjust- ments ⁹ US\$m	Currency translation ¹¹ US\$m	2008 at 2009 exchange rates ¹⁶ US\$m	2009 as reported US\$m	2009 adjust- ments ¹⁰ US\$m	2009 under- lying US\$m	Re- ported change ¹³ %	Under- lying change ¹³ %
Net interest income	5,698		21	5,719	4,195		4,195	(26)	(27)
Net fee income	2,580		10	2,590	2,669		2,669	3	3
Changes in fair value ¹⁴	5	(5)			(1)	1			
Other income	1,871		7	1,878	2,604		2,604	39	39
Net operating income ¹⁵	10,154	(5)	38	10,187	9,467	1	9,468	(7)	(7)
Loan impairment charges and other credit risk provisions	(765)		(2)	(767)	(500)		(500)	35	35
Net operating income	9,389	(5)	36	9,420	8,967	1	8,968	(4)	(5)
Operating expenses	(3,943)		(16)	(3,959)	(3,946)		(3,946)		
Operating profit	5,446	(5)	20	5,461	5,021	1	5,022	(8)	(8)
Income from associates	15			15	8		8	(47)	(47)
Profit before tax	5,461	(5)	20	5,476	5,029	1	5,030	(8)	(8)

*For footnotes, see
page 83.*

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)**Rest of Asia-Pacific***2010 compared with 2009*

	2009 as reported US\$m	2009 adjust- ments US\$m	Currency translation ¹¹ US\$m	2009 at 2010 exchange rates ¹² US\$m	2010 as reported US\$m	2010 adjust- ments ¹⁰ US\$m	2010 under- lying US\$m	Re- ported change ¹³ %	Under- lying change ¹³ %
Net interest income	3,539		240	3,779	3,828	(31)	3,797	8	
Net fee income	1,557		109	1,666	1,932	(3)	1,929	24	16
Changes in fair value ¹⁴	(3)	3			(1)	1		67	
Other income	2,910		208	3,118	3,473	(197)	3,276	19	5
Net operating income¹⁵	8,003	3	557	8,563	9,232	(230)	9,002	15	5
Loan impairment charges and other credit risk provisions	(896)		(74)	(970)	(439)		(439)	51	55
Net operating income	7,107	3	483	7,593	8,793	(230)	8,563	24	13
Operating expenses	(4,450)		(291)	(4,741)	(5,143)	19	(5,124)	(16)	(8)
Operating profit	2,657	3	192	2,852	3,650	(211)	3,439	37	21
Income from associates	1,543		13	1,556	2,252		2,252	46	45
Profit before tax	4,200	3	205	4,408	5,902	(211)	5,691	41	29

*2009 compared with
2008*

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	2008 as reported US\$m	2008 adjust- ments US\$m	Currency translation ¹¹ US\$m	2008 at 2009 exchange rates ¹⁶ US\$m	2009 as reported US\$m	2009 adjust- ments ¹⁰ US\$m	2009 under- lying US\$m	Re- ported change ¹³ %	Under- lying change ¹³ %
Net interest income	3,937		(165)	3,772	3,539	(53)	3,486	(10)	(8)
Net fee income	1,867		(80)	1,787	1,557	(6)	1,551	(17)	(13)
Changes in fair value ¹⁴	3	(3)			(3)	3			
Other income	3,174		(205)	2,969	2,910	(18)	2,892	(8)	(3)
Net operating income ¹⁵	8,981	(3)	(450)	8,528	8,003	(74)	7,929	(11)	(7)
Loan impairment charges and other credit risk provisions	(852)		31	(821)	(896)		(896)	(5)	(9)
Net operating income	8,129	(3)	(419)	7,707	7,107	(74)	7,033	(13)	(9)
Operating expenses	(4,704)		208	(4,496)	(4,450)	31	(4,419)	5	2
Operating profit	3,425	(3)	(211)	3,211	2,657	(43)	2,614	(22)	(19)
Income from associates	1,297		27	1,324	1,543		1,543	19	17
Profit before tax	4,722	(3)	(184)	4,535	4,200	(43)	4,157	(11)	(8)

*For footnotes, see
page 83.*

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)**Middle East***2010 compared with 2009*

	2009 as reported US\$m	2009 adjust- ments ¹ US\$m	Currency translation ¹¹ US\$m	2009 at 2010 exchange rates ¹² US\$m	2010 as reported US\$m	2010 adjust- ments ¹⁰ US\$m	2010 under- lying US\$m	Re- ported change ¹³ %	Under- lying change ¹³ %
Net interest income	1,485		(4)	1,481	1,367		1,367	(8)	(8)
Net fee income	625		(1)	624	677		677	8	8
Other income	484		(1)	483	366	42	408	(24)	(16)
Net operating income¹⁵	2,594		(6)	2,588	2,410	42	2,452	(7)	(5)
Loan impairment charges and other credit risk provisions	(1,334)		1	(1,333)	(627)		(627)	53	53
Net operating income	1,260		(5)	1,255	1,783	42	1,825	42	45
Operating expenses	(1,001)		3	(998)	(1,078)		(1,078)	(8)	(8)
Operating profit	259		(2)	257	705	42	747	172	191
Income from associates	196			196	187		187	(5)	(5)
Profit before tax	455		(2)	453	892	42	934	96	106

*2009 compared with
2008*

2008

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	2008 as reported US\$m	2008 adjust- ments, ¹ US\$m	Currency translation ¹¹ US\$m	at 2009 exchange rates ¹⁶ US\$m	2009 as reported US\$m	2009 adjust- ments ¹⁰ US\$m	2009 under- lying US\$m	Re- ported change ¹³ %	Under- lying change ¹³ %
Net interest income	1,556		(7)	1,549	1,485		1,485	(5)	(4)
Net fee income	691		(4)	687	625		625	(10)	(9)
Other income	421		(7)	414	484		484	15	17
Net operating income ¹⁵	2,668		(18)	2,650	2,594		2,594	(3)	(2)
Loan impairment charges and other credit risk provisions	(279)		(1)	(280)	(1,334)		(1,334)	(378)	(376)
Net operating income	2,389		(19)	2,370	1,260		1,260	(47)	(47)
Operating expenses	(959)		11	(948)	(1,001)		(1,001)	(4)	(6)
Operating profit	1,430		(8)	1,422	259		259	(82)	(82)
Income from associates	316		1	317	196		196	(38)	(38)
Profit before tax	1,746		(7)	1,739	455		455	(74)	(74)

*For footnotes, see
page 83.*

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)**North America***2010 compared with 2009*

	2009 as reported US\$m	2009 adjust- ments ⁹ US\$m	Currency translation ¹¹ US\$m	2009 at 2010 exchange rates ¹² US\$m	2010 as reported US\$m	2010 adjust- ments ¹⁰ US\$m	2010 under- lying US\$m	Re- ported change ¹³ %	Under- lying change ¹³ %
Net interest income	13,670		134	13,804	12,439		12,439	(9)	(10)
Net fee income	4,817		56	4,873	3,664		3,664	(24)	(25)
Changes in fair value ¹⁴	(3,688)	3,688			142	(142)			
Other income/ (expense)	1,506		12	1,518	802	(66)	736	(47)	(52)
Net operating income¹⁵	16,305	3,688	202	20,195	17,047	(208)	16,839	5	(17)
Loan impairment charges and other credit risk provisions	(15,664)		(53)	(15,717)	(8,295)		(8,295)	47	47
Net operating income	641	3,688	149	4,478	8,752	(208)	8,544	1,265	91
Operating expenses (excluding goodwill impairment)	(8,391)		(103)	(8,494)	(8,322)		(8,322)	1	2
Operating profit/(loss)	(7,750)	3,688	46	(4,016)	430	(208)	222		
Income from associates	12			12	24		24	100	100
	(7,738)	3,688	46	(4,004)	454	(208)	246		

**Profit/(loss)
before tax***2009 compared
with 2008*

	2008 as reported US\$m	2008 adjust- ments ⁹ US\$m	Currency translation ¹¹ US\$m	2008 at 2009 exchange rates ¹⁶ US\$m	2009 as reported US\$m	2009 adjust- ments ¹⁰ US\$m	2009 under- lying US\$m	Re- ported change ¹³ %	Under- lying change ¹³ %
Net interest income	15,218		(79)	15,139	13,670		13,670	(10)	(10)
Net fee income	5,227		(33)	5,194	4,817		4,817	(8)	(7)
Changes in fair value ¹⁴	3,444	(3,444)			(3,688)	3,688			
Other income/(expense)	(2,710)		(4)	(2,714)	1,506		1,506		
Net operating income ¹⁵	21,179	(3,444)	(116)	17,619	16,305	3,688	19,993	(23)	13
Loan impairment charges and other credit risk provisions	(16,795)		(8)	(16,803)	(15,664)		(15,664)	7	7
Net operating income	4,384	(3,444)	(124)	816	641	3,688	4,329	(85)	431
Operating expenses (excluding goodwill impairment)	(9,359)		58	(9,301)	(8,391)		(8,391)	10	10
Goodwill impairment	(10,564)			(10,564)				100	100
Operating loss	(15,539)	(3,444)	(66)	(19,049)	(7,750)	3,688	(4,062)	50	79
Income from associates	11		(1)	10	12		12	9	20
Loss before tax	(15,528)	(3,444)	(67)	(19,039)	(7,738)	3,688	(4,050)	50	79

*For footnotes, see
page 83.*

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Report of the Directors: Operating and Financial Review (continued)**Latin America***2010 compared with 2009*

	2009 as reported US\$m	2009 adjust- ments ¹⁰ US\$m	Currency translation ¹¹ US\$m	2009 at 2010 exchange rates ¹² US\$m	2010 as reported US\$m	2010 adjust- ments ¹⁰ US\$m	2010 under- lying US\$m	Re- ported change ¹³ %	Under- lying change ¹³ %
Net interest income	5,573		468	6,041	6,311		6,311	13	4
Net fee income	1,729		147	1,876	1,749		1,749	1	(7)
Other income	1,722		169	1,891	1,671		1,671	(3)	(12)
Net operating income¹⁵	9,024		784	9,808	9,731		9,731	8	(1)
Loan impairment charges and other credit risk provisions	(2,526)		(253)	(2,779)	(1,544)		(1,544)	39	44
Net operating income	6,498		531	7,029	8,187		8,187	26	16
Operating expenses	(5,375)		(453)	(5,828)	(6,394)		(6,394)	(19)	(10)
Operating profit	1,123		78	1,201	1,793		1,793	60	49
Income from associates	1			1	2		2	100	100
Profit before tax	1,124		78	1,202	1,795		1,795	60	49

*2009 compared with
2008*

2008

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	2008 as reported US\$m	2008 adjust- ments ¹⁰ US\$m	Currency translation ¹¹ US\$m	at 2009 exchange rates ¹⁶ US\$m	2009 as reported US\$m	2009 adjust- ments ¹⁰ US\$m	2009 under- lying US\$m	Re- ported change ¹³ %	Under- lying change ¹³ %
Net interest income	6,458		(783)	5,675	5,573		5,573	(14)	(2)
Net fee income	2,167		(291)	1,876	1,729		1,729	(20)	(8)
Other income	1,888	(71)	(220)	1,597	1,722		1,722	(9)	8
Net operating income ¹⁵	10,513	(71)	(1,294)	9,148	9,024		9,024	(14)	(1)
Loan impairment charges and other credit risk provisions	(2,492)		294	(2,198)	(2,526)		(2,526)	(1)	(15)
Net operating income	8,021	(71)	(1,000)	6,950	6,498		6,498	(19)	(7)
Operating expenses	(5,990)		709	(5,281)	(5,375)		(5,375)	10	(2)
Operating profit	2,031	(71)	(291)	1,669	1,123		1,123	(45)	(33)
Income from associates	6		(2)	4	1		1	(83)	(75)
Profit before tax	2,037	(71)	(293)	1,673	1,124		1,124	(45)	(33)

For footnotes, see
page 83.

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)

Disclosure controls

The Group Chief Executive 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 2010. Based upon that evaluation, the Group Chief Executive and Group Finance Director concluded that our disclosure controls and procedures as of 31 December 2010 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 controls over financial reporting during the year ended 31 December 2010 that has materially affected, or is reasonably likely to materially affect, HSBC Holdings' internal controls over financial reporting.

Management's assessment of internal controls over financial reporting

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 controls over financial reporting as of 31 December 2010. In making the assessment, management used the framework for Directors' 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 2010, the Group's internal controls over financial reporting were effective.

KPMG Audit Plc, which has audited the consolidated financial statements of the Group for the year ended 31 December 2010, 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 235 and 236.

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)**Other information****Funds under management and assets held in custody**

Funds under management

	2010 US\$bn	2009 US\$bn
Funds under management		
At 1 January	857	735
Net new money	42	36
Value change	33	76
Exchange and other	(7)	10
At 31 December	925	857

	2010 US\$bn	2009 US\$bn
Funds under management by business		
Global Asset Management	439	423
Global Private Banking	277	251
Affiliates	3	3
Other	206	180
At 31 December	925	857

Funds under management at 31 December 2010 amounted to US\$925bn, an increase of 8% when compared with 2009. Both Global Asset Management and GPB fund holdings increased, reflecting an improvement in equity market performance and strong net inflows.

Global Asset Management funds, including emerging market funds, increased by 4% to US\$439bn as a result of market performance gains and strong net inflows, particularly in Europe and Asia, partly offset by adverse foreign exchange movements. We remain one of the world's largest emerging market asset managers with funds under management of US\$145bn at 31 December 2010 in countries outside North America, Western Europe, Japan and Australia.

GPB funds increased by 10% in 2010 to US\$277bn, driven by an improvement in equity market performance and strong net inflows which benefited from our strength in emerging markets, hiring of key relationship managers and cross-business referrals. Client assets, which include funds under management and cash deposits and provide an indicator of the scale of GPB, increased by US\$23bn to US\$390bn due to the increase in funds under management.

Other funds under management, which are mainly held by a corporate trust business in Asia, increased by 14% to US\$206bn.

We announced in November 2010 that, with effect from 1 March 2011, Retail Banking and Wealth Management will be managed as a single global business from Hong Kong. Global Asset Management will become part of this business and will be transferred from GB&M.

Assets held in custody and under administration

Custody is the safekeeping and servicing of securities and other financial assets on behalf of clients. At 31 December 2010, we held assets as custodian of US\$5.7 trillion, 9% higher than the US\$5.2 trillion held at 31 December 2009. This was mainly driven by an increase in the market value of assets and favourable foreign exchange movements.

Our assets under administration business, which includes the provision of various support function activities including the valuation of portfolios of securities and other financial assets on behalf of clients, complements the custody business. At 31 December 2010, the value of assets held under administration by the Group amounted to US\$2.7 trillion, compared with US\$2.8 trillion in 2009.

Property

At 31 December 2010, we operated from some 9,950 operational properties worldwide, of which approximately 2,500 were located in Europe, 3,100 in Hong Kong and Rest of Asia-Pacific, 800 in North America, 3,350 in Latin America and 200 in the Middle East. These properties had an area of approximately 71.3m square feet (2009: 70.8m square feet).

Our freehold and long leasehold properties, together with all our leasehold land in Hong Kong, were valued in 2010. The value of these properties was US\$7.1bn (2009: US\$4.1bn) in excess of their carrying amount in the consolidated balance sheet. In addition, properties with a net book value of US\$1,133m were held for investment purposes.

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.

Further details are included in Note 25 on the Financial Statements.

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)**Legal proceedings, investigations and regulatory matters**

As a result of an August 2002 restatement of previously reported consolidated financial statements and other corporate events, including the 2002 settlement with 46 State Attorneys General relating to real estate lending practices, Household International (now HSBC Finance) and certain former officers were named as defendants in a class action law suit, *Jaffe v Household International Inc, et al* No 2. C 5893 (N.D.Ill, filed 19 August 2002). Following a jury trial concluded in April 2009, the Court issued a ruling on 22 November 2010, within the second phase of the case to determine actual damages, that claim forms should be mailed to class members and also set out a method for calculating damages for class members who filed claims. Despite the jury verdict and the November 2010 ruling, HSBC continues to believe that it has meritorious defences and intends to seek an appeal of the Court's ruling. The timing and outcome of the resolution of this matter is uncertain. Given the complexity and uncertainties associated with the actual determination of damages, including but not limited to the number of class members that may file valid claims, the number of claims that can be substantiated by class members providing adequate documentation, the reduction of trading losses by any trading gains made over the relevant period, the determination of reliance by class members on the financial statements, and whether any given class member was the beneficial owner of the shares, HSBC is unable at this time to estimate reliably the amount of any damages or range of possible damages that could arise, but they could be significant.

In December 2008, Bernard L Madoff (Madoff) was arrested for running a Ponzi scheme and a trustee was appointed for the liquidation of his firm, Bernard L Madoff Investment Securities LLC (Madoff Securities), a Securities and Exchange Commission (SEC) registered broker-dealer and investment adviser. Madoff subsequently pleaded guilty to various charges and is serving a 150-year prison sentence. Various non-US HSBC companies provide custodial, administration and similar services to a number of funds incorporated outside the US whose assets were invested with Madoff Securities and have been named as defendants in suits in the US, Ireland, Luxembourg and other jurisdictions. There are many factors which may affect the range of possible outcomes including, but not limited to, the circumstances of the fraud, the multiple jurisdictions in which the proceedings have been brought, and the number of different plaintiffs and defendants in such proceedings. The cases are at an early stage. For these reasons, among others, it is not practicable at this time for HSBC to estimate reliably the aggregate liabilities or ranges of liabilities that may arise as a result of all such claims but they could be significant. In any event, HSBC considers that it has good defences to these claims and will continue to defend them vigorously.

HSBC Bank USA entered into a consent cease and desist order with the Office of the Comptroller of the Currency and the indirect parent of that company, HSBC North America, entered into a consent cease and desist order with the Federal Reserve Board in the first week of October 2010. These actions require improvements for an effective compliance risk management programme across the Group's US businesses, including US Bank Secrecy Act (BSA) and Anti Money Laundering (AML) compliance. Steps continue to be taken to address the requirements of these Orders and to ensure that compliance and effective policies and procedures are maintained.

Various HSBC Group companies are the subject of ongoing investigations, including Grand Jury subpoenas and other requests for information, by US Government agencies, including the US Attorney's Office, the US Department of Justice and the New York County District Attorney's Office. These investigations pertain to, among other matters, HSBC Bank USA's bank note and foreign correspondent banking businesses and its compliance with BSA and AML controls, as well as various HSBC companies' compliance with Office of Foreign Asset Control (OFAC) requirements, and adherence by certain customers to US tax reporting requirements.

The consent cease and desist orders do not preclude additional enforcement actions against HSBC Bank USA or HSBC North America by bank regulatory or law enforcement agencies, including actions to recover civil money

penalties, fines and other financial penalties relating to activities which were the subject of the cease and desist orders. In addition, it is likely that there could be some form of formal enforcement action in respect of some or all of the ongoing investigations. Actual or threatened enforcement actions against other financial institutions for breaches of BSA, AML and OFAC requirements have resulted in settlements involving fines and penalties, some of which have been significant depending on the individual circumstances of each action. The ongoing investigations are at an early stage. Based on the facts currently known, it is not practicable at this time for HSBC to determine the terms on which the ongoing investigations will be resolved or the timing of such resolution or for HSBC

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)

to estimate reliably the amounts, or range of possible amounts, of any fines and/or penalties. As matters progress, it is possible that any fines and/or penalties could be significant.

For further information see Note 44 on the Financial Statements.

Foreclosures

US State and federal officials recently announced investigations into the procedures followed by mortgage servicing companies and banks, including HSBC Finance and HSBC Bank USA, relating to foreclosures. We have responded to all related inquiries and co-operated with all applicable investigations, including a joint examination by staffs of the Federal Reserve Board and the Office of the Comptroller of the Currency as part of their broad review of industry foreclosure practices. Following the examination, our examiners issued supervisory letters noting certain deficiencies in our processing, preparation and signing of affidavits and other documents supporting foreclosures, and in the governance of and resources devoted to our foreclosure processes, including the evaluation and monitoring of third party law firms retained to effect our foreclosures. Certain other processes were deemed adequate. Management is reviewing foreclosures where judgement has not yet been entered and will correct deficient documentation and re-file affidavits where necessary. We have suspended foreclosures until such time as we have substantially addressed noted deficiencies in our processes. We are engaged in discussions with the Federal Reserve Board and the Office of the Comptroller of the Currency regarding the terms of consent cease and desist orders, which will prescribe actions to address the deficiencies noted in the joint examination. We expect the consent orders will be finalised shortly. While the impact of the consent orders depends on the final terms, we believe they have the potential to increase our operational, reputational and legal risk profiles and expect implementation of their provisions will require significant and managerial resources. In addition, the consent orders will not preclude further actions against HSBC Bank USA or HSBC Finance by bank regulatory or other agencies, including the imposition of fines and civil money penalties. We are unable at this time, however, to determine the likelihood of any further action or the amount of fines or penalties, if any, that may be imposed by the regulators or agencies.

Data security

In March 2010 HSBC Private Bank (Suisse) SA announced that it had been the victim of a significant data theft. In 2010, HSBC Private Bank (Suisse) SA conducted a comprehensive review of its information security procedures, formulated and implemented major security upgrade programmes and continued a multi-million franc investment programme in systems to ensure industry-leading security standards. It also reviewed and strengthened risk management and operational controls and will continue to invest in these areas. In March 2010, the Swiss Financial Market Supervisory Authority (FINMA) launched an investigation into the circumstances of the data theft. On 22 February 2011 a notice of decision with a declaratory ruling was received from FINMA following such investigation which found that, because of deficiencies in its internal organisation and oversight of its IT activities, HSBC Private Bank (Suisse) SA had breached various regulatory provisions. HSBC Private Bank (Suisse) SA is currently considering the details of the notice of decision and actions required by FINMA.

Footnotes to Overview and Operating and Financial Review

Financial highlights

- 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. The third interim dividend for 2009 of US\$0.08 was paid on 13 January 2010. The fourth interim dividend for 2009 of US\$0.10 was paid on 5 May 2010. First, second and third interim dividends for 2010, each of US\$0.08 per ordinary share, were paid on 7 July 2010, 6 October 2010 and 12 January 2011, respectively. Note 11 on the Financial Statements provides more information on the dividends*

declared in 2010. On 28 February 2011 the Directors declared a fourth interim dividend for 2010 of US\$0.12 per ordinary share in lieu of a final dividend, which will be payable to ordinary shareholders on 5 May 2011 in cash in US dollars, or in pounds sterling or Hong Kong dollars at exchange rates to be determined on 27 April 2011, with a scrip dividend alternative. The reserves available for distribution at 31 December 2010 were US\$36,013m.

Quarterly dividends of US\$15.50 per 6.2% non-cumulative Series A US 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 US dollar preference share, were paid on 15 March 2010, 15 June 2010, 15 September 2010 and 15 December 2010.

Quarterly coupons of US\$0.508 per security were paid with respect to 8.125% capital securities on 15 January 2010, 15 April 2010, 15 July 2010 and 15 October 2010.

Quarterly coupons of US\$0.45 and US\$0.50 per security were paid with respect to 8% capital securities on 15 September 2010 and on 15 December 2010, respectively.

- 2 *Return on invested capital is based on the profit attributable to ordinary shareholders. Average invested capital is measured as average*

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Report of the Directors: Operating and Financial Review (continued)

total shareholders' equity after adding back goodwill previously written-off directly to reserves, deducting average equity preference shares issued by HSBC Holdings and deducting/(adding) average reserves for unrealised gains/(losses) on effective cash flow hedges and available-for-sale securities. This measure reflects capital initially invested and subsequent profit.

- 3 *The return on average total shareholders' equity is defined as profit attributable to shareholders of the parent company divided by average total shareholders' equity.*
- 4 *The cost efficiency ratio is defined as total operating expenses divided by net operating income before loan impairment charges and other credit risk provisions.*
- 5 *Each ADS represents five ordinary shares.*
- 6 *Total shareholder return is defined as the growth in share value and declared dividend income during the relevant period.*
- 7 *The Financial Times Stock Exchange 100 Index, the Morgan Stanley Capital International World Index and the Morgan Stanley Capital International World Bank Index.*
- 8 *HBEU is HSBC Bank plc; HBAP is The Hongkong and Shanghai Banking Corporation; and HBUS is HSBC Bank USA. Figures provided for HSBC Bank plc and The Hongkong and Shanghai Banking Corporation incorporate the major overseas branches of these entities. Subsidiaries of these entities are not included unless there is unrestricted transferability of liquidity between the subsidiaries and the parent.*
- 9 *This comprises our other main banking subsidiaries and, as such, includes businesses spread across a range of locations, in many of which we may require a higher ratio of net liquid assets to customer liabilities to reflect local market conditions.*

Reconciliations of reported and underlying profit/(loss) before tax

- 10 *These columns comprise the net increments or decrements in profits in the current year compared with the previous year which are attributable to acquisitions or disposals of subsidiaries and/or movements in fair value of own debt attributable to credit spread. The inclusion of acquisitions and disposals is determined in the light of events each year.*
- 11 *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.*
- 12 *Excluding adjustments in 2009.*
- 13 *Positive numbers are favourable; negative numbers are unfavourable.*
- 14 *Changes in fair value due to movements in own credit spread on long-term debt issued. This does not include the fair value changes due to own credit spread on structured notes issued and other hybrid instruments included within trading liabilities.*

- 15 *Net operating income before loan impairment charges and other credit risk provisions.*
- 16 *Excluding adjustments in 2008.*
- Financial summary**
- 17 *This footnote is intentionally left blank.*
- 18 *The effect of the bonus element of the rights issue in 2009 has been included within the basic and diluted earnings per share.*
- 19 *Dividends per ordinary share expressed as a percentage of earnings per ordinary share.*
- 20 *Net interest income includes the cost of funding trading assets, while the related external revenues are reported in trading income. In our customer group results, the cost of funding trading assets is included with GB&M's net trading income as interest expense.*
- 21 *Gross interest yield is the average annualised interest rate earned on average interest-earning assets (AIEA).*
- 22 *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.*
- 23 *Net interest margin is net interest income expressed as an annualised percentage of AIEA.*
- 24 *Other interest-earning assets includes intercompany eliminations.*
- 25 *Interest income on trading assets is reported as Net trading income in the consolidated income statement.*
- 26 *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.*
- 27 *This includes interest-bearing bank deposits only.*
- 28 *Interest expense on financial liabilities designated at fair value is reported as Net income on financial instruments designated at fair value in the consolidated income statement, other than interest on own debt which is reported in Interest Expense .*
- 29 *This includes interest-bearing customer accounts only.*
- 30 *The cost of internal funding of trading assets was US\$902m (2009: US\$1,309m; 2008: US\$5,547m) 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.*
- 31 *Net trading income includes income of US\$23m (2009: expense of US\$444m; 2008: income of US\$529m), associated with changes in the fair value of issued structured notes and other hybrid instrument liabilities derived from movements in HSBC issuance spreads.*
- 32 *Other changes in fair value include gains and losses arising from changes in the fair value of derivatives that are managed in conjunction with HSBC's long-term debt issued.*
- 33 *Discretionary participation features.*

34 *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.*

Consolidated balance sheet

35 *Net of impairment allowances.*

36 *The calculation of capital resources, capital ratios and risk-weighted assets for 2008 to 2010 is on a Basel II basis. 2006 and 2007 comparatives are on a Basel I basis.*

37 *Capital resources are total regulatory capital, the calculation of which is set out on page 180.*

38 *Includes perpetual preferred securities, details of which can be found in Note 34 on the Financial Statements.*

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)

39 *The definition of net asset value per share is total shareholders' equity, less non-cumulative preference shares and capital securities, divided by the number of ordinary shares in issue.*

40 *Currency translation is the effect of translating the assets and liabilities of subsidiaries and associates for the previous year-end at the rates of exchange applicable at the current year-end.*

Economic profit

41 *Expressed as a percentage of average invested capital.*

42 *Average invested capital is measured as average total shareholders' equity after:
adding back the average balance of goodwill amortised pre-transition to IFRSs or subsequently written-off, directly to reserves (less goodwill previously amortised in respect of the French regional banks sold in 2008);*

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 and other equity instruments issued by HSBC Holdings; and

deducting average reserves for unrealised gains/(losses) on effective cash flow hedges and available-for-sale securities.

43 *Return on invested capital is profit attributable to ordinary shareholders of the parent company, which can be found in Note 12 on the Financial Statements on page 296.*

Customer groups and global businesses and Geographical regions

44 *The main items reported under 'Other' are certain property activities, unallocated investment activities, centrally held investment companies, gains arising from the dilution of interests in associates, movements in the fair value of own debt designated at fair value (the remainder of the Group's gain on own debt is included in GB&M) and HSBC's holding company and financing operations. The results also include net interest earned on free capital held centrally, operating costs incurred by the head office operations in providing stewardship and central management services to HSBC, and costs incurred by the Group Service Centres and Shared Service Organisations and associated recoveries. At 31 December 2010, there was a US\$188m gain arising from the dilution of interests in associates (2009: nil; 2008: nil) and adverse fair value movements on HSBC's own debt designated at fair value were US\$0.1bn (2009: US\$6.5bn adverse; 2008: US\$6.6bn favourable).*

45 *Assets by geographical region and customer group include intra-HSBC items. These items are eliminated, where appropriate, under the heading 'Intra-HSBC items'.*

46 *Net operating income before loan impairment charges and other credit risk provisions.*

47 *Loan impairment charges and other credit risk provisions.*

48 *Share of profit in associates and joint ventures.*

- 49 *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.*
- 50 *In 2010, Global Markets included a favourable fair value movement of US\$23m on the widening of credit spreads on structured liabilities (2009: adverse fair value movement of US\$444m; 2008: favourable fair value movement of US\$529m).*
- 51 *Total income earned on securities services products in the Group amounted to US\$1.5bn (2009: US\$1.4bn; 2008: US\$2.2bn), of which US\$1.5bn was in GB&M (2009: US\$1.4bn; 2008: US\$2.1bn) and US\$29m was in CMB (2009: US\$19m; 2008: US\$45m).*
- 52 *Total income earned on payments and cash management products in the Group amounted to US\$4.4bn (2009: US\$4.1bn; 2008: US\$5.8bn), of which US\$3.3bn was in CMB (2009: US\$3.1bn; 2008: US\$4.1bn) and US\$1.1bn was in GB&M (2009: US\$1.1bn; 2008: US\$1.7bn).*
- 53 *Total income earned on other transaction services in the Group amounted to US\$2.3bn (2009: US\$1.8bn; 2008: US\$1.8bn), of which US\$1.6bn was in CMB relating to trade and supply chain (2009: US\$1.3bn; 2008: US\$1.3bn) and US\$636m was in GB&M of which US\$523m related to trade and supply chain (2009: US\$382m; 2008: US\$355m) and US\$113m related to banknotes and other (2009: US\$125m; 2008: US\$126m).*
- 54 *In each Group entity, Balance Sheet Management is responsible for managing liquidity and funding under the supervision of the local ALCO. Balance Sheet Management also manages the structural interest rate position of the entity within a Global Markets limit structure.*
- 55 *Other in GB&M includes net interest earned on free capital held in the global business not assigned to products.*
- 56 *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 GB&M. HSBC's Balance Sheet Management business, reported within GB&M, provides funding to the trading businesses. To report GB&M's 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.*
- 57 *Net insurance claims incurred and movement in liabilities to policyholders.*
- 58 *Employee expenses comprises costs directly incurred by each customer group. The reallocation and recharging of employee and other expenses directly incurred in the Other customer group is shown in Other operating expenses .*
- 59 *RWAs are non-additive across geographical regions due to market risk diversification effects within the Group.*
- 60 *France primarily comprises the domestic operations of HSBC France, HSBC Assurances Vie and the Paris branch of HSBC Bank plc.*
- 61 *Hong Kong Government certificates of indebtedness were reclassified from PFS to Other at 1 January 2010.*
- 62 *US includes the impairment of goodwill in respect of PFS North America.*

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Average balance sheet

- 63 *Interest income on trading assets is reported as Net trading income in the consolidated income statement.*
- 64 *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.*
- 65 *Brazilian operations comprise HSBC Bank Brasil S.A.-Banco Múltiplo and subsidiaries, plus HSBC Serviços e Participações Limitada.*
- 66 *This includes interest-bearing bank deposits only. See page 31(n) for an analysis of all bank deposits.*
- 67 *Interest expense on financial liabilities designated at fair value is reported as Net income on financial instruments designated at fair value in the consolidated income statement, other than interest on own debt which is reported in Interest Expense .*
- 68 *This includes interest-bearing customer accounts only. See page 31(o) for an analysis of all customer accounts.*
- 69 *Net interest margin is calculated as net interest income divided by average interest earning assets.*
- 70 *For the purpose of calculating the ratios, earnings consist of income from continuing operations before taxation and non-controlling 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, dividends on preference shares and other equity instruments, as applicable, and the proportion of rental expense deemed representative of the interest factor.*
- 71 *Trading assets and financial investments held by GB&M in North America include financial assets which may be repledged or resold by counterparties.*
- 72 *Derivative assets and derivative liabilities of GB&M include derivative transactions between different regions of GB&M.*
- 73 *Ratio excludes trading loans classified as in default.*

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)**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 our compliance with the 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 183.

Our operations throughout the world are regulated and supervised by approximately 540 different central banks and regulatory authorities in those jurisdictions in which we have 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 we operate 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; 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 we operate will determine to some degree our ability to expand into new markets, the services and products that we will be able to offer in those markets and how we structure specific operations. As a result of government interventions in response to recent global economic conditions, it is widely anticipated that there will be a substantial increase in government regulation and supervision of the financial services industry, including the imposition of higher capital requirements, heightened disclosure standards and restrictions on certain types of transaction structures.

The FSA supervises us 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, our principal areas of operation.

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, investments and sales of personal financial services.

In addition to its role as our lead regulator, the FSA is responsible for authorising and supervising all our businesses in the UK which require authorisation under FSMA. These include deposit-taking, retail banking, life and general insurance, pensions, investments, mortgages, custody and share dealing businesses, and treasury and capital markets activity. HSBC Bank is our 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 our supervisor 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* on pages 177 to 182.

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)

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% 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 our senior executives to discuss our adherence to the FSA's prudential guidelines. They also regularly discuss fundamental matters relating to our 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. In light of current conditions, we have experienced an increased level of ongoing interaction with the FSA.

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 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 has the power to serve a notice of objection on persons if they are no longer deemed to be fit and proper to be controllers of the bank, 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 HKMA implemented Basel II with effect from 1 January 2007 for all Authorised Institutions incorporated in Hong Kong.

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.

US regulation and supervision

We are subject to extensive federal and state supervision and regulation in the US. Banking laws and regulations of the Board of Governors of the Federal Reserve System (the Federal Reserve Board), the Office of the Comptroller of the Currency (the OCC) and the Federal Deposit Insurance Corporation (the FDIC) govern many aspects of our US business.

On 21 July 2010, the United States enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), which provides a broad framework for significant regulatory changes that will extend to almost every area of US financial regulation. Implementation of Dodd-Frank will require further detailed rulemaking over several

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)

years by different US regulators, including the Department of the Treasury, the Federal Reserve Board, the FDIC, the Securities and Exchange Commission (the SEC), the Commodity Futures Trading Commission and the newly created Financial Stability Oversight Council (the FSOC) and Consumer Financial Protection Bureau (the Consumer Bureau), and uncertainty remains about the final details, timing and impact of the rules.

HSBC and our 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), as a result of our control of HSBC Bank USA, N.A., McLean, Virginia (HBUS); and HSBC Trust Company (Delaware), N.A., Wilmington, Delaware (HTCD). HSBC North America Holdings Inc. (HNAH), formed to hold our US and Canadian operations is also a bank holding company. Both HSBC and HNAH are registered as financial holding companies (FHCs) under the BHCA, and, accordingly, may affiliate with securities firms and insurance companies and engage in other activities that are financial in nature or incidental or complementary to activities that are financial in nature. The ability of HSBC and HNAH 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 our US depository institution subsidiaries 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.

Under Dodd-Frank, in order for HNAH to meet the criteria for qualifying as a financial holding company, it will be required to be well capitalised.

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.

The two US banks, HBUS and HTCD are subject to regulation and examination primarily by the OCC, secondarily by the FDIC, and by the Federal Reserve Board. Banking laws and regulations restrict many aspects of their operations and administration, including the establishment and maintenance of branch offices, capital and reserve requirements, deposits and borrowings, investment and lending activities, payment of dividends and numerous other matters.

In December 2007, US regulators published a final rule regarding Risk-Based Capital Standards: Advanced Capital Adequacy Framework – Basel II. This final rule represents the US adoption of Basel II. The final rule became effective on 1 April 2008, and requires large bank holding companies, including HNAH, to adopt its provisions no later than 1 April 2011. HNAH has established comprehensive Basel II implementation project teams comprised of risk management specialists representing all risk disciplines. 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).

Dodd-Frank also establishes minimum risk-based capital requirements that shall not be less than the currently generally applicable capital requirements, which shall serve as a floor for any capital requirements the bank regulatory agencies may require. We expect that the US bank regulatory agencies will adopt regulations to implement Basel III as well as various provisions of Dodd-Frank. We cannot be certain of the impact the new capital regulations will have on our US capital ratios at this time.

HSBC Bank USA and HTCD are subject to risk-based assessments from the FDIC, which insures deposits generally to a maximum of US\$250,000 per depositor for domestic deposits. Dodd-Frank provides for unlimited

deposit insurance for certain non-interest-bearing transactions accounts for the period to 31 December 2012. Due to projected shortfalls in the FDIC fund as a result of continuing bank failures, the FDIC required all insured banks, including HBUS and HTCD, to prepay their insurance premium for the years 2010, 2011 and 2012.

Dodd-Frank changes the FDIC's risk-based deposit insurance assessment framework primarily by basing assessments on an FDIC-insured institution's total assets less tangible equity rather than US domestic deposits, which is expected to shift a greater portion of the aggregate assessments to large FDIC-insured institutions. The new large bank pricing system will result in higher assessment

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rates for banks with high-risk asset concentrations, less stable balance sheet liquidity, or potentially higher loss severity in the event of failure.

Our 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.

Dodd-Frank will limit the ability of banking entities to sponsor or invest in private equity or hedge funds or to engage in certain types of proprietary trading in the United States unrelated to serving clients. Dodd-Frank also provides regulators with tools to provide greater capital, leverage and liquidity requirements and other prudential standards, particularly for financial institutions that pose significant systemic risk. However, in imposing heightened capital, leverage, liquidity and other prudential standards on non-US banks, the Federal Reserve Board is directed to take into account the principle of national treatment and equality of competitive opportunity, and the extent to which the foreign bank is subject to comparable home country standards.

US regulators will also be able to restrict the size and growth of systemically significant non-bank financial companies and large interconnected bank holding companies and will be required to impose bright-line debt-to-equity ratio limits on financial companies that the FSOC determines pose a grave threat to financial stability. Furthermore, Dodd-Frank provides for an extensive framework for the regulation of over-the-counter (OTC) derivatives, including mandatory clearing, exchange trading and transaction reporting of certain OTC derivatives, as well as rules regarding the registration of swap dealers and major swap participants, and related capital, margin, business conduct, record keeping and other requirements applicable to such entities. Dodd-Frank also requires broader regulation of hedge funds and private equity funds, and imposes new requirements with respect to asset securitisation activities. In addition, effective by July 2012, Dodd-Frank will require that the lending limits applicable to HBUS and HTCD take into account credit exposure from derivative transactions, securities borrowing and lending transactions, and repurchase and reverse repurchase agreements.

Dodd-Frank also grants the SEC discretionary rule-making authority to impose a new fiduciary standard on brokers, dealers and investment advisers, and expands the extraterritorial jurisdiction of US courts over actions brought by the SEC or the United States with respect to violations of the anti-fraud provisions in the Securities Act, the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940. In addition, regulations which the FSOC, the Consumer Bureau or other regulators may adopt could affect the nature of the activities which our FDIC-insured depository institution subsidiaries may conduct, and may impose restrictions and limitations on the conduct of such activities. Dodd-Frank also establishes a new regime for the orderly liquidation of systemically significant financial companies and authorises assessments on financial institutions with US\$50bn or more in consolidated assets to repay outstanding debts owed to the Treasury in connection with a liquidation of a systemically significant financial company under the new insolvency regime.

Implementation of Dodd-Frank and related final regulations could result in additional costs or limit or restrict the way we conduct our business, although uncertainty remains about the details, impact and timing of these reforms.

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 relating to the countries subject to US economic sanctions programmes administered by the Office of Foreign Assets Control as well as those subject to UN, UK and EU sanctions. HSBC Group policy requires that relevant Group offices should adhere to the letter and spirit of all applicable laws and

regulations. HSBC's business activities include banking services for nationals of, and clients domiciled in, some of the countries. The Group had a small representative office in Tehran, Iran which was closed in December 2010.

HSBC Bank USA entered into a Consent Cease & Desist Order with OCC, and HNAH entered into a Consent Cease & Desist Order with the Federal Reserve Board in the first week of October 2010. These Orders require improvement for an effective Compliance Risk Management Programme including anti-money laundering controls across the Group's US businesses. Steps continue to be taken to address the requirements of these Orders and to ensure that

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compliance and effective policies and procedures are maintained.

The US State Department has designated certain countries (Cuba, Iran, 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. HSBC Group Policy requires all Group companies to comply to the extent applicable with US law and regulation, including the country and individual sanctions promulgated by OFAC sanctions. This means that not only must US subsidiaries and US nationals comply with OFAC regulations, but that HSBC subsidiaries outside the US which are not US persons must not participate in US Dollar business that would, if conducted by a US person, contravene the OFAC sanctions. The HSBC Group does not consider that its business activities with counterparties in, or directly relating to, these countries are material to its business, and such activities represented a very small part of total assets at 31 December 2010 and total revenues for the year ended 31 December 2010.

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<u>Residual value risk</u>	174

1 Unaudited 2 Audited 3 Audited where indicated

Risk Profile

(Unaudited)

Managing our risk profile

A strong balance sheet remains core to our philosophy.

We have reduced our exposure to higher risk asset classes while achieving controlled balance sheet growth.

We have ensured that our portfolio remains diversified across regions, client sectors and risk types.

Maintaining capital strength and strong liquidity position

Our tier 1 capital ratio remains strong at 12.1%.

We have sustained our strong liquidity position throughout 2010.

The ratio of customer advances to deposits remains below 80%.

Strong governance

Our Global Risk function is independent of our commercial and operational functions.

Robust risk governance and accountability is embedded across the Group.

The Board, advised by the Group Risk Committee, approves our risk appetite.

A global risk operating model provides consistent and effective oversight across all six regions and our customer groups and global businesses.

Our top and emerging risks

Challenges to our business operations.

Challenges to our governance and internal control systems.

Macro-economic and geopolitical risk.

Macro-prudential and regulatory risks to our business model.

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)

Managing risk

(Unaudited)

The continued growth in our business in 2010 was achieved while ensuring risks were assumed in a measured manner and in line with our appetite for such risks. This approach is encapsulated within our risk appetite framework. It is approved by the Group Risk Committee and the Board.

The framework is maintained at Group, regional, global business and customer group levels, operating through governance bodies, processes and metrics designed to assist in risk management. Risk appetite statements define, at various levels of the business, the qualitative and quantitative expressions of the risks which HSBC is prepared to embrace in alignment with its strategy and business plans. Quantitative metrics are assigned to five key categories: earnings, capital and liquidity, impairments and expected losses, risk category and diversification and scenario stress testing. Measurement against the metrics serves to:

guide underlying business activity, ensuring it is aligned to risk appetite statements;

determine risk-adjusted remuneration;

enable the key underlying assumptions to be monitored and, where necessary, adjusted through subsequent business planning cycles; and

promptly identify business decisions needed to mitigate risk.

Report of the Group Risk Committee

Further commentary on risk appetite, risk governance and stress testing can be found within the Report of the Group Risk Committee, on pages 197 to 201 of the Governance section.

The diversification of our lending portfolio across our regions, together with our broad range of customer groups and products, ensure that we are not dependent on a few countries or markets to generate income and growth. Our geographical diversification also provides impetus to our strategies for growth in faster-growing markets and those with international connectivity.

During 2010, the financial markets were dominated by concerns over sovereign debt. In addition, the perception that the world economic recovery remained fragile created volatility in certain financial markets. Further quantitative easing from the US temporarily boosted market confidence, but inflationary pressures remained an issue, especially in the UK and some emerging markets.

With an ever-changing economic and financial environment, we pro-actively review our risk profile and, where appropriate, introduce new risk measures. Stress testing will continue to evolve to ensure that it considers prevailing concerns.

Our insurance operations are managed with regard to the effects on financial markets of prevailing economic conditions such as the low yields available on fixed-interest investments and continuing high unemployment rates, particularly in the US and Europe.

Capital and liquidity

We maintained a strong balance sheet during 2010 while reducing the overall risk in our portfolio. Our balance sheet assets grew by 4% during the year while our credit risk-weighted assets fell by 1.4%. This was achieved, in part, by concentrating on our growth in core portfolios and running off those that were not core to our business.

In addition, we reduced our loan impairment charges and other credit risk provisions from US\$26.5bn in 2009 to US\$14.0bn in 2010, reflecting the general improvement in the credit quality of our portfolio.

Preserving our strong capital position has long been, and will remain, a key priority for HSBC. We are equipped to respond to the capital requirements imposed by Basel III, which are discussed further on pages 181 and 182, and to sustain future growth. We have adopted a holistic approach to testing the sensitivities of our capital plans against a number of scenarios; our approach to scenario stress testing analysis is discussed below.

We continue to maintain a strong liquidity position and are well positioned for the new regulatory landscape. The run-off of the HSBC Finance portfolio and the continuing moderation of market conditions in 2010 contributed to our strong liquidity position.

Risk governance

(Unaudited)

Our strong risk governance reflects the importance placed by the Board on shaping the Group's risk strategy and managing risks effectively. It is supported by a clear policy framework of risk ownership, by the cascading from the GMB of balanced scorecards that align business and risk objectives, and by the accountability of all officers for identifying, assessing and managing risks within the scope of their assigned responsibilities. This personal accountability, reinforced by the governance structure, experience and mandatory learning, helps to foster throughout HSBC a disciplined and constructive culture of risk management and control.

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Scenario stress testing

We conduct a range of Group stress testing scenarios including, but not limited to, severe global economic downturn, country, sector and counterparty failures, and a variety of projected major operational risk events. The outcomes of the stress scenarios are used to assess the potential impact on demand for regulatory capital against its supply. We also participate, where appropriate, in scenario analyses requested by regulatory bodies.

In addition to the suite of risk scenarios considered for the Group, each major HSBC subsidiary conducts regular macro-economic and event-driven scenario analyses specific to its region.

Stress testing is also used by the market risk discipline to evaluate the potential impact on portfolio values of events or movements in a set of financial variables.

Challenges and uncertainties

(Unaudited)

The top and emerging risks identified through our risk management processes and outlined in the Report of the Group Risk Committee on page 199, present challenges and uncertainties as we carry out our activities. These are considered in further detail below.

Business operations, governance and control

Operational risks are inherent in our business

We are exposed to many types of operational risk, including fraudulent and other criminal activities (both internal and external), breakdowns in processes or procedures, or systems failure or unavailability. We are also subject to the risk of disruption to our business arising from events that are wholly or partially beyond our control (for example: natural disasters, acts of terrorism, epidemics and transport or utility failures) which may give rise to losses in service to customers and/or economic loss to HSBC. All of these risks are also applicable where we rely on external suppliers or vendors to provide services to us and our customers.

The reliability and security of our information and technology infrastructure and its customer databases, for example to combat internet fraud, are crucial to maintaining our banking applications and processes and to protecting the HSBC brand. Critical system failure, any prolonged loss of service availability or any material breach of data security, particularly involving confidential customer data,

could cause serious damage to our ability to serve our clients, could breach regulations under which we operate and could cause long-term damage to our business and brand. Information security and the management of increasing operational complexity are two of the key emerging operational risks that we face.

We are subject to legal and compliance risks, which could have an adverse effect on the Group

Legal and compliance risks arise from a variety of sources with the potential to cause harm to HSBC and our ability to operate. These issues require us to deal appropriately with potential conflicts of interest; regulatory requirements; ethical issues; anti-money laundering laws and regulations; privacy laws; information security policies; sales and trading practices; and the conduct of companies with which we are associated. Failure to address these issues appropriately may give rise to additional legal and compliance risk to HSBC, with an increase in the number of litigation claims and the amount of damages asserted against us, or subject us to regulatory enforcement actions, fines or penalties or reputational damage.

We are subject to tax-related risks in the countries in which we operate

We are subject to the substance and interpretation of tax laws in all countries in which we operate. Failure to respond to changes in tax rates and comply with procedures required by tax authorities could lead to increased tax charges, including financial or operating penalties.

Liquidity and funding risks are inherent in our business

HSBC's business model is founded upon having ready access to financial resources whenever required to meet our obligations and grow our business. To this end, our entities seek to maintain a diversified and stable funding base comprising core retail and corporate customer deposits and institutional balances, and certain entities augment this with amounts of long-term wholesale funding. In addition, we hold portfolios of highly liquid assets to enable us to respond to unusual liquidity requirements. We continue to maintain a strong liquidity position, moving into the new regulatory landscape.

Where markets become illiquid, the value at which financial instruments can be realised is highly uncertain, and capital resources may shrink as valuations decline. Rating agency downgrades of

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Report of the Directors: Operating and Financial Review (continued)

instruments to which we have exposure, or threats of downgrades, can exacerbate the effect. The liquidity of those HSBC entities that utilise long-term wholesale markets could be constrained by an inability to access them due to a variety of unforeseen market dislocations or interruptions.

The market conditions that the financial services industry experienced during the recent financial crisis highlighted the significant benefits of a diversified core deposit base, leading to increased competition for such deposits and the greater risk of deposit migration between competitors.

Our GB&M business operates in many markets affected by illiquidity and is subject to the threat of extreme price volatility, either directly or indirectly, through exposures to securities, loans, derivatives and other commitments. Although market conditions continued to moderate in 2010, it is difficult to predict if this trend will continue and, if conditions worsen, which of our markets, products and other businesses will be affected. Any repeat of these factors could have an adverse effect on our results.

Macro-economic and geopolitical

Prevailing economic and market conditions may adversely affect our results

Our earnings are affected by global and local economic and market conditions. Following the problems experienced in financial markets in 2007-8, concerted government action in 2009 paved the way for a general improvement in the economic environment in 2010, though recovery was variable between regions. The eurozone economies came under greater pressure, the dominant concern being over sovereign debt. The financial services industry continued to face an unusually high degree of uncertainty.

With unemployment remaining high, consumer confidence weak in developed markets and amid signs of emerging inflationary pressures, economic conditions remain fragile and volatile. Some countries may recover only slowly to past levels of growth, with the possibility of a return to recessionary conditions in more sluggish economies, while others which are growing rapidly may need to undertake major adjustments to counter the formation of asset bubbles. This could have an adverse effect on our operating results. In particular, we may face the following challenges in connection with these events to our operations and operating model:

- the demand for borrowing from creditworthy customers may diminish if economic activity slows;
- trade and capital flows may contract as a result of protectionist measures being introduced in certain markets, or on the emergence of geopolitical risks;

- a prolonged period of low interest rates will constrain, for example through margin compression and low returns on assets, net interest income we earn on our excess deposits;

- our ability to borrow from other financial institutions or to engage in funding transactions could be adversely affected by market disruption, for example in the event of contagion from stress in the eurozone sovereign and financial sectors;

- market developments may depress consumer and business confidence, for example if growth in the US or the UK were to be poor, adversely affecting both asset prices and payment patterns and leading to increases in delinquencies and default rates, write-offs and loan impairment charges beyond our expectations. The effect of such conditions in 2010 and previous years on our North American retail business is described on page 110.

We are subject to political and economic risks in the countries in which we operate

We responded effectively to the financial crisis and, more recently, the sovereign debt problems within the eurozone, where we continued during 2010 to support our operations and carry out wider market functions.

As an organisation which operates in 87 countries and territories, however, our results are subject to the risk of loss from unfavourable political developments, currency fluctuations, social instability and changes in government policies on such matters as expropriation, authorisations, international ownership, interest-rate caps, foreign exchange transferability and tax in the jurisdictions in which we operate.

The ability of HSBC's subsidiaries and affiliates to pay dividends could be restricted by changes in official banking measures, exchange controls and other requirements. We prepare our accounts in US dollars, but because a substantial portion of our assets, liabilities, funds under management, revenues and expenses are denominated in other currencies, changes in foreign exchange rates have an effect on our reported income, cash flows and shareholders' equity.

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We have significant exposure to counterparty risk within our portfolio

We have exposure to virtually all major industries and counterparties, and we routinely execute transactions with counterparties in financial services, including brokers and dealers, commercial banks, investment banks, mutual and hedge funds, and other institutional clients. Many of these transactions expose us to credit risk in the event of default by our counterparty or client. Financial institutions are necessarily interdependent because of trading, clearing, counterparty or other relationships. As a consequence, a default by, or decline in market confidence in, individual institutions, or anxiety about the financial services industry generally, can lead to further individual and/or systemic losses. Our credit risk may remain high if the collateral taken to mitigate counterparty risk cannot be realised or has to be liquidated at prices which are insufficient to recover the full amount of our loan or derivative exposure. For further information relating to the major risk areas, see **Areas of Special Interest** on page 103.

Macro-prudential and regulatory

We face a number of challenges in regulation and supervision

Financial services providers face increased regulation and supervision, with more stringent and costly requirements in the areas of capital and liquidity management and of compliance relating to conduct of business and the integrity of financial services delivery. Increased government intervention and control over financial institutions, together with measures to reduce systemic risk, could significantly alter the competitive landscape.

Recent regulatory and supervisory developments have largely been shaped by the leaders, Finance Ministers and Central Bank Governors of the Group of Twenty nations (the G20), who delegated the development and issuance of standards to the Basel Committee of Banking Supervisors (the Basel Committee). The G20 also established the Financial Stability Board (FSB) to assess vulnerabilities affecting the financial system as a whole, as well as to monitor and advise on market developments and best practice in meeting regulatory standards.

In looking to address the systemic failures that caused the financial crisis of 2007-8, the authorities asserted two primary objectives: to establish a resilient system to reduce substantially the risks of failure of financial institutions and, in case failure in the end proved unavoidable, to have in place measures to achieve orderly resolution without cost to taxpayers. Governments and regulators have embarked on significant change in the regulation of the financial system, highlighting the following priorities:

a stronger international framework for prudential regulation, ensuring significantly increased liquidity and regulatory capital buffers and enhanced quality of capital;

convergence towards a single set of high-quality, global, independent accounting standards, with particular focus on accounting for financial instruments and off-balance sheet exposures;

strengthening the regulation of hedge funds and credit rating agencies, and improving the infrastructure for derivative transactions, including central counterparty clearing of over-the-counter derivatives;

design and implementation of a system which will allow for the restructuring or resolution of financial institutions, without taxpayers ultimately bearing the burden;

an increased role for colleges of supervisors to coordinate oversight of systemically significant institutions such as HSBC, and effective coordination of resolution regimes for failed banks;

measures on financial sector compensation arrangements to prevent excessive short-term risk taking and mitigate systemic risk on a globally consistent basis; and

a fair and substantial contribution by the financial sector towards paying for any burden associated with government interventions, where they occur, to repair and reduce risks from the financial system or to fund the resolution of problems.

Measures proposed by the Basel Committee to increase resilience in the financial system

The Basel Committee, following consultation, impact analyses and draft proposals during 2010, issued final proposals in December 2010, known as Basel III, on the twin areas of capital and liquidity, the key aspects of which are set out below.

Risk weightings: increased weightings for the trading book and re-securitisations are planned for implementation by the end of 2011. A fundamental review of the trading book will continue during 2011.

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Quality of capital: there is renewed emphasis on common equity as the principal component of tier 1 capital, with increased deductions from shareholders' equity (calculated on an accounting basis) to determine the level of regulatory capital. The phasing-in periods for these new deductions will start in 2014, to be fully implemented by 2018.

Minimum ratios: a new minimum common equity requirement of 4.5% is to be implemented in full by 1 January 2015. An additional capital conservation buffer of 2.5% in common equity effectively acts as a trigger for restrictions on management actions (such as the payment of dividends or bonuses) so that the capital structure can be rebuilt. This will be phased in between 1 January 2016 and 1 January 2019. In addition to these core tier 1 levels, additional requirements from the Basel Committee for tier 1 capital of 1.5% and tier 2 capital of 2.0%, by 2019, will lift the minimum total capital requirement for banks to around 10.5%.

Countercyclical capital buffer: the Basel Committee has finalised its proposals for a countercyclical capital buffer of 2.5% in common equity, to be built up in periods of excess credit growth compared with GDP growth. It is not clear how these may operate in practice and there is doubt that either supervisors or the market would support release of a buffer again as the economic cycle turned.

Total leverage: the Committee has proposed a leverage ratio of 3% of total assets to constrain aggregate size relative to the capital base. It is intended that an observation period of parallel running from 2013 to 2017 should enable a minimum standard to become mandatory in 2018.

Liquidity and funding: a new minimum standard, the Liquidity Coverage Ratio, has been developed to promote the short-term resilience of a bank's liquidity risk profile. A Net Stable Funding Ratio has also been introduced to provide a sustainable maturity structure of assets and liabilities. As it is not yet clear what unintended consequences these measures may have, they will be phased in after observation periods in 2015 and 2018, respectively.

The Basel Committee is also developing an approach, due by the end of 2011, to defining Global Systemically Important Financial Institutions (G-SIFIs) to introduce more rigorous oversight and co-ordinated assessment of their risks through international supervisory colleges, provide for higher levels of capital and liquidity resilience, and require mandatory recovery and resolution plans with institution-specific crisis cooperation agreements between cross-border crisis management groups.

A strong capital position has long been, and will remain, a key priority for HSBC. We are equipped to respond to the capital requirement standards of Basel III, as discussed further on pages 181 and 182, and to sustain future growth.

Other measures

Remuneration: the FSB has issued principles on remuneration designed to guide regional and national authorities in establishing appropriate regimes to align remuneration in a risk-based manner with the long-term interests of stakeholders. The EU has implemented rule changes in the Capital Requirements Directive which impact the balance between fixed and variable remuneration, establishing limits on the percentage of bonus which can be paid in cash. Approaches to the issue remain divergent globally, however.

Bank levies: a number of levies are being raised on banks, notably by the UK, Germany and France. There is a renewed US proposal to raise a financial crisis responsibility fee on certain financial companies with assets over US\$50bn. The European levies are calculated with reference to measures of stability of funding, in order to encourage more stable structures. In the UK, for example, the levy is to be charged at a rate of 0.075% on all liabilities excluding insured deposits and certain other elements, but with a lower rate for longer-term liabilities and uninsured deposits. Germany will hypothecate levy income to create resolution funds to support failing banks, while in other jurisdictions it will accrue to general tax revenues. Under the draft legislation, the UK levy is not tax deductible and does not meet the definition of an income tax for income statement purposes. For

indicative purposes only, the UK levy that would be payable based on the closing 2010 balance sheet, after taking into account announced changes to deposit protection schemes in 2011, is estimated at US\$0.6bn.

Other taxes: other areas of financial sector taxation being considered by the authorities are a Financial Activities Tax (FAT), a tax on profit and remuneration, and a Financial

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Transaction Tax (FTT) applied to a specified range of financial transactions. An IMF report for the G20 in 2010 saw merit in an FAT but did not recommend an FTT as it was felt not to address the key issues within the G20 mandate and might have unintended economic and regulatory consequences. In its Seoul 2010 communique the G20 did not promote any one approach for adoption. Both the European Commission and the UK Government are considering an FAT, which the former believes can work at EU level. The EU also sees merit in an FTT but, recognising the dependency on an international consensus, will continue to work within the G20 for its adoption.

The Volcker Rule : under the Dodd-Frank Act, banking organisations with operations in the US face limits on their ability to sponsor or invest in private equity or hedge funds and are prohibited from engaging in certain types of proprietary trading in the US, subject to a number of exceptions allowing an entity significant leeway to engage in client-serving trading, such as market-making and underwriting, and risk-mitigating hedging activities. The ultimate impact of these restrictions will depend on how US regulators implement them in rulemaking.

Derivatives and central counterparties regulation: as agreed by the G20, the authorities are seeking to reduce systemic risk and volatility relating to derivatives trading. In the US, the Dodd-Frank Act provides for an extensive regulatory framework for over the counter (OTC) derivatives. In addition to the mandatory clearing, exchange trading and reporting of certain swaps and security-based swaps, it also requires the registration of swap dealers and major swap participants, making them subject to capital, margin, business conduct and record-keeping regulations. In September 2010, the EU Commission presented proposals, currently in negotiation, for all standardised OTC derivatives to be reported to trade repositories and centrally cleared by the end of 2012. The proposal disincentivises derivative contracts which are not eligible for central clearing by proposing higher capital requirements. Exemptions for foreign exchange swaps and forwards are currently being considered.

Markets in financial instruments: the European Commission is conducting a major Review of the Markets in Financial Instruments Directive, potentially to extend its scope beyond equities to other asset classes including bonds, exchange-traded funds and other equity-like and non-equity instruments, and to promote their trading on exchanges and other markets that will be subject to regulation. It also proposes giving additional power to regulators to ban trading in products that are eligible to be cleared but for which no clearing solution is currently available.

The UK Independent Commission on Banking: this Commission was established to examine issues of banking activity and competition, including the potential impact on financial markets of a number of options to separate the retail and wholesale activities of universal banks. Responses to the opening consultation have been published and the Commission intends to publish an interim report in April 2011, with further consultation prior to a final report in September 2011. The UK Government is not bound to adopt the Commission's recommendations.

Recovery and resolution plans: such plans are considered a key element in improving the ability of regulators to rescue (or resolve) firms when they get into difficulties without putting taxpayer monies at risk. Studies and pilots have been initiated by various official bodies on the resolution of financial firms and the international coordination of such exercises; the UK authorities have been at the forefront of work to develop approaches to this subject. The EU has consulted on a new framework for crisis management, including so-called bail-in creditor write-down resolution. Legislative proposals are expected mid-2011. In the US, the Dodd-Frank Act established the Orderly Liquidation Authority which will ultimately provide a bank-like receivership process for large financial companies; resolution plans will be required of large financial institutions and rules for early remediation will be forthcoming. There is currently no consistent approach and a number of key areas need to be addressed, including an international legal framework for addressing competing creditor claims and the application of collateral.

Restructuring of regulatory bodies

In addition to the significant volume of new regulation emanating from the Basel Committee and others, the landscape of financial sector regulation itself in a number of major Western countries is undergoing significant change, presenting its own challenges to the industry and its implementation of proposed reforms.

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In the EU, new authorities for segments of the financial services sector took up their powers with effect from 1 January 2011: the European Banking Authority, the European Securities Markets Authority and the European Insurance and Occupational Pension Authority. In addition, a European Systemic Risk Board will consider emerging macro-prudential risks.

In the UK, the Financial Services Authority's (FSA) prudential supervisory responsibilities will be transferred in 2012 to a Bank of England agency, the Prudential Regulatory Authority, while the Financial Conduct Authority will act as a single regulator of conduct of business for both retail and wholesale firms.

In the US, the Dodd-Frank Act re-assigns responsibilities of existing agencies, demising the Office of Thrift Supervision and creating others, including a Financial Stability Oversight Council to address systemic matters and a Bureau of Consumer Protection.

Implementation risks

The extensive programme of regulatory change carries significant implementation risks for authorities and industry participants alike, including:

Disparities in implementation: many official measures are proposals in development and negotiation, and have yet to be enacted into regional and national legislation. These processes could result in differing, fragmented and overlapping implementation around the world, leading to risks of regulatory arbitrage, a far from level competitive playing-field and increased compliance costs, especially for large, global financial institutions such as HSBC.

Timetable and market expectations: while the Basel Committee has announced the timetable for its core proposals in Basel III, it remains uncertain how these and other measures will play out in practice, for instance with regard to differences in approach between Basel III and the Dodd-Frank Act in the US. Meanwhile, market expectations will exert pressure on institutions to assess and effect compliance well in advance of official timetables.

Wider economic impact and unforeseen consequences: while the conclusions of official and industry studies have diverged, the measures proposed will clearly impact on financial and economic activity in ways that cannot yet be clearly foreseen. For example, higher capital requirements may seriously constrain the availability of funds for lending to support economic recovery.

Credit Risk

Credit risk management

(Audited)

Credit risk is the risk of financial loss if a customer or counterparty fails to meet a payment obligation under a contract. It arises principally from direct lending, trade finance and leasing business, but also from off-balance sheet products such as counterparty risk guarantees and credit derivatives, and from our holdings of debt securities. Of the risks in which we engage, credit risk generates the largest regulatory capital requirement.

Principal objectives of our credit risk management

to maintain across HSBC a strong culture of responsible lending and a robust risk policy and control framework;

to both partner and challenge our businesses in defining, implementing and continually re-evaluating our risk appetite under actual and scenario conditions; and

to ensure there is independent, expert scrutiny of credit risks, their costs and their mitigation.

The Credit Risk department fulfils the role of an independent credit control unit as part of the Global Risk function in our Group Management Office (GMO). Credit approval authorities are delegated by the Board to the most senior Chief Executive Officers, who receive commensurate authorities from their own boards. In each major subsidiary, a Chief Risk Officer reports to the local Chief Executive Officer on credit-related issues, while maintaining a direct functional reporting line to the Group Chief Risk Officer in GMO.

Credit quality

(Audited)

Our credit risk rating systems and processes differentiate exposures in order to highlight those with greater risk factors and higher potential severity of loss. In the case of individually significant accounts, risk ratings are reviewed regularly and any amendments are implemented promptly. Within our retail businesses, risk is assessed and managed using a wide range of risk and pricing models to generate portfolio data.

Our risk rating system facilitates the internal ratings-based (IRB) approach under Basel II adopted by the Group to support calculation of our minimum credit regulatory capital requirement. For further details, see Credit quality of financial instruments on page 114.

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Special attention is paid to problem exposures in order to accelerate remedial action. Where appropriate, our operating companies use specialist units to provide customers with support in order to help them avoid default wherever possible.

The high-level oversight and management of credit risk provided globally by the Credit Risk function within GMO

to formulate Group credit policy. Compliance, subject to approved dispensations, is mandatory for all operating companies which must develop local credit policies consistent with Group policies;

to guide operating companies on our appetite for credit risk exposure to specified market sectors, activities and banking products and controlling exposures to certain higher-risk sectors;

to undertake an independent review and objective assessment of risk. Global Risk assesses all commercial non-bank credit facilities and exposures over designated limits, prior to the facilities being committed to customers or transactions being undertaken;

to monitor the performance and management of portfolios across the Group;

to control exposure to sovereign entities, banks and other financial institutions, as well as debt securities which are not held solely for the purpose of trading;

to set our policy on large credit exposures, ensuring that concentrations of exposure by counterparty, sector or geography do not become excessive in relation to our capital base, and remain within internal and regulatory limits;

to control our cross-border exposures (see page 102);

to maintain and develop our risk rating framework and systems. The Group Chief Risk Officer chairs the Credit Risk Analytics Oversight Committee, which reports to the Risk Management Meeting and oversees risk rating model governance for both wholesale and retail business;

to report on retail portfolio performance, high risk portfolios, risk concentrations, country limits and cross-border exposures, large impaired accounts, impairment allowances and stress testing results and recommendations to the Risk Management Meeting, the Group Risk Committee and the Board; and

to act on behalf of HSBC Holdings as the primary interface, for credit-related issues, with the Bank of England, the FSA, local regulators, rating agencies, analysts and counterparts in major banks and non-bank financial institutions.

Group and regional Credit Review and Risk Identification teams regularly review exposures and processes in order to provide an independent, rigorous assessment of credit risk across the HSBC Group, reinforce secondary risk management controls and share best practice. Internal audit, as a tertiary control function, focuses on risks with a global perspective and on the design and effectiveness of primary and secondary controls, carrying out oversight audits via sampling of global/regional control frameworks, themed audits of key or emerging risks and project audits to assess major change initiatives.

Impairment assessment

(Audited)

It is HSBC's policy that each operating company creates allowances for impaired loans promptly and consistently.

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.

When impairment losses occur, we reduce the carrying amount of loans and advances through the use of an allowance account. When impairment of available-for-sale financial assets and held-to-maturity financial investments occurs, we reduce the carrying amount of the asset directly. For further details, see *Critical accounting policies* on page 33.

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. For secured loans, write-off generally occurs after receipt of any proceeds from the realisation of security. Write-off may occur earlier when the net realisable value of any collateral has been determined and there is no reasonable expectation of further recovery.

In HSBC Finance, the carrying amounts of residential mortgage and second lien loans in excess of net realisable value are written off at or before the time foreclosure is completed or settlement is reached with the borrower. If there is no reasonable expectation of recovery, and foreclosure is pursued, the loan is normally written off no later than the end of the month in which the loan becomes 180 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. Write-off periods may be extended, generally to no more than 360 days past due but in very exceptional circumstances exceeding that figure, in a few countries where local regulation or legislation constrain earlier write-off, or where the realisation of collateral for secured real estate lending extends to this time.

In the event of bankruptcy or analogous proceedings, write-off may occur earlier than at the

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periods stated above. Collections procedures may continue after write-off.

Cross-border exposures

We assess the vulnerability of countries to foreign currency payment restrictions, including economic and political factors, when considering impairment allowances on cross-border exposures. Impairment allowances are assessed in respect of all qualifying exposures within vulnerable 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; and

performing facilities with a principal (excluding security) of US\$1m or below and/or with maturity dates shorter than three months.

Credit exposure

Maximum exposure to credit risk

(Audited)

Our credit exposure is spread across a broad range of asset classes, including derivatives, trading assets, loans and advances to customers, loans and advances to banks and financial investments. In 2010, exposure to credit risk remained diversified across classes. However, the balance changed compared with the end of 2009, reflecting growth in loans and advances to both customers and banks, and a reduction in trading assets due to the deconsolidation of the Constant Net Asset Value funds.

Residential mortgage lending continued to represent a significant portion of our overall credit exposure. In 2010, the credit quality of our mortgage portfolios generally improved, reflecting economic conditions and a stabilisation of unemployment and house prices in most of our key markets. Despite some improvement, economic and housing market conditions remain difficult across the US and we remain focused on running off the residual balances in our Consumer Lending and Mortgage Services portfolio. In the UK, we grew our residential mortgage lending exposure as a result of successful promotional campaigns and competitive pricing. The consistent application of conservative underwriting criteria ensured the credit quality of our residential mortgage exposure in the UK remained satisfactory and well secured. Our exposure to the Hong Kong residential mortgage market also grew during 2010; we continued to lend conservatively with an average loan-to-value ratio of 55% on new mortgage sales. For further commentary on personal lending, see *Areas of special interest* Personal Lending on page 106.

Loss experience: percentage of total loan impairment charges and other credit risk provisions

(Unaudited)

2010
US\$14,039m

2009
US\$26,488m

The following table presents the maximum exposure to credit risk from balance sheet and off-balance sheet financial instruments, before taking account of any collateral held or other credit enhancements (unless such credit

enhancements meet accounting offsetting requirements). For financial assets recognised on the balance sheet, the maximum exposure to credit risk equals their carrying amount; for financial guarantees and similar contracts granted, it is the maximum amount that we 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 facilities, it is generally the full amount of the committed facilities.

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Report of the Directors: Operating and Financial Review (continued)

*Maximum exposure to credit risk
(Audited)*

	At 31 December 2010			At 31 December 2009		
	Maximum exposure US\$m	Offset US\$m	Exposure to credit risk (net) US\$m	Maximum exposure US\$m	Offset US\$m	Exposure to credit risk (net) US\$m
Cash and balances at central banks	57,383		57,383	60,655		60,655
Items in the course of collection from other banks	6,072		6,072	6,395		6,395
Hong Kong Government certificates of indebtedness	19,057		19,057	17,463		17,463
Trading assets	343,966	(4,189)	339,777	386,070	(8,496)	377,574
Treasury and other eligible bills	25,620		25,620	22,346		22,346
Debt securities	168,268		168,268	201,598		201,598
Loans and advances to banks	70,456		70,456	78,126		78,126
Loans and advances to customers	79,622	(4,189)	75,433	84,000	(8,496)	75,504
Financial assets designated at fair value	19,593		19,593	22,198		22,198
Treasury and other eligible bills	159		159	223		223
Debt securities	18,248		18,248	20,718		20,718
Loans and advances to banks	315		315	354		354
Loans and advances to customers	871		871	903		903
Derivatives	260,757	(197,501)	63,256	250,886	(189,606)	61,280
Loans and advances held at amortised cost	1,166,637	(91,966)	1,074,671	1,076,012	(91,127)	984,885
to banks	208,271	(3,099)	205,172	179,781	(116)	179,665
to customers	958,366	(88,867)	869,499	896,231	(91,011)	805,220
Financial investments	392,772		392,772	360,034		360,034

Treasury and other similar bills	57,129		57,129	58,434		58,434
Debt securities	335,643		335,643	301,600		301,600
Other assets	30,371	(29)	30,342	36,373	(4)	36,369
Endorsements and acceptances	10,116	(29)	10,087	9,311	(4)	9,307
Other	20,255		20,255	27,062		27,062
Financial guarantees and similar contracts	49,436		49,436	53,251		53,251
Loan and other credit-related commitments ¹	602,513		602,513	558,050		558,050
	2,948,557	(293,685)	2,654,872	2,827,387	(289,233)	2,538,154

For footnote, see page 174.

Collateral and other credit enhancements

(Audited)

Collateral held against financial instruments presented in the above table is described in more detail below.

Loans and advances

Although collateral can be an important mitigant of credit risk, it is our policy to lend on the basis of the customer's capacity to repay rather than to rely on the value of security offered. Depending on the customer's standing and the type of product, facilities may be provided unsecured.

We employ the following principal collateral types:

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 cash, debt securities and equities in support of trading facilities.

In addition, credit derivatives and securitisation structures are used to hedge or transfer credit risk within our loan portfolio.

The loans and advances offset adjustment in the table above primarily relates to customer loans and deposits, and balances arising from repo and reverse repo transactions. The offset relates to balances where there is a legally enforceable right of offset in the event of counterparty default, and where, as a result, there is a net exposure for credit risk management purposes. However, as there is no intention to settle these balances on a net basis under normal circumstances, they do not qualify for net presentation for accounting purposes.

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Report of the Directors: Operating and Financial Review (continued)

We do 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.

Derivatives

The International Swaps and Derivatives Association (ISDA) Master Agreement is our preferred agreement for documenting derivatives activity. It provides the contractual framework within which dealing activity across a full range of OTC 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 another pre-agreed termination event occurs. It is common, and our 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 counterparty risk inherent in outstanding positions. The majority of our CSAs are with financial institutional clients.

The derivative offset amount in the above table relates to exposures where the counterparty has an offsetting derivative exposure with HSBC, a master netting arrangement is in place and the credit risk exposure is managed on a net basis, or the position is specifically collateralised, normally in the form of cash. At 31 December 2010, the total amount of such offsets was US\$197.5bn (2009: US\$189.6bn), of which US\$178.3bn (2009: US\$168.5bn) were offsets under a master netting arrangement, US\$19.0bn (2009: US\$21.0bn) were collateral received in cash and US\$0.2bn (2009: US\$0.1bn) were other collateral. These amounts do not qualify for net presentation for accounting purposes, as settlement may not actually be made on a net basis.

Treasury, other eligible bills and debt securities

Debt securities, treasury and other eligible bills are generally unsecured except for asset-backed securities (ABS) and similar instruments, which are secured by pools of financial assets.

Items in the course of collection from other banks

Settlement risk arises in any situation where a payment in cash, securities or equities is made in the expectation of a corresponding receipt of cash, securities or equities. Daily settlement limits are established for counterparties to cover the aggregate of our transactions with each one on any single day.

We substantially mitigate settlement risk on many transactions, particularly those involving securities and equities, by settling through assured payment systems or on a delivery-versus-payment basis.

Concentration of exposure*(Audited)*

Concentrations of credit risk arise when a number of counterparties or exposures have comparable economic characteristics, or such counterparties are engaged in similar activities or operate in the same geographical areas or industry sectors, so that their collective ability to meet contractual obligations is uniformly affected by changes in economic, political or other conditions. We use a number of controls and measures to minimise undue concentration of exposure in our portfolios across industry, country and customer groups. These include portfolio and counterparty limits, approval and review controls, and stress testing.

Wrong-way risk is an aggravated form of concentration risk and arises when there is a strong correlation between the counterparty's probability of default and the mark-to-market value of the underlying transaction. We use a range of procedures to monitor and control wrong-way risk, including requiring entities to obtain prior approval before undertaking wrong-way risk transactions outside pre-agreed guidelines.

Securities held for trading*(Unaudited)*

A detailed analysis of securities held for trading is set out in Note 15 on the Financial Statements and an analysis of credit quality is provided on page 114.

Debt securities, treasury and other eligible bills

(Unaudited)

HSBC's holdings of corporate debt, ABS and other securities were spread across a wide range of issuers and geographical regions, with 25% invested in securities issued by banks and other financial institutions. A more detailed analysis of financial investments is set out in Note 21 on the Financial Statements and an analysis by credit quality is provided on page 114.

At 31 December 2010, our insurance businesses held diversified portfolios of debt and equity securities designated at fair value (2010: US\$28bn; 2009: US\$25bn) and debt securities classified as financial investments (2010: US\$38bn; 2009: US\$35bn). A more detailed analysis of securities held by the insurance businesses is set out on page 162.

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Report of the Directors: Operating and Financial Review (continued)**Derivatives***(Unaudited)*

Derivative assets at 31 December 2010 were US\$261bn, a rise of 4% from 31 December 2009. Our single largest exposure was to interest rate derivatives, and this balance increased in 2010 reflecting downward shifts in yield curves, partly offset by higher netting from increased trading with clearing houses. The notional value of outstanding contracts also rose, reflecting an increase in the number of open transactions compared with 2009. In addition our exposure to exchange rate derivatives rose as a result of increased volatility.

Loans and advances*(Unaudited)*

On a reported basis, gross loans and advances to customers (excluding the financial sector) at 31 December 2010 increased by US\$52bn or 6% from 31 December 2009. On a constant currency basis the increase was 7%. The rise was primarily due to growth in Asia, mainly in trade-related lending and, to a lesser extent, our commercial real estate and personal lending portfolios, as the region prospered.

Summary of gross loans and advances to customers

(Unaudited)

The following commentary is on a constant currency basis:

Personal lending was US\$425bn, a decline of 2% compared with the end of 2009 as growth in residential mortgage lending was more than offset by lower other personal lending balances. Personal lending represented 43% of our total lending to customers. At US\$269bn, residential mortgage lending constituted the Group's largest concentration in a single exposure type. In 2010, residential mortgage lending increased by 4%, reflecting strong growth in new mortgage sales in Hong Kong and the UK. This was partly offset by a 12% decline in the US, mainly due to the continued run-off of our Consumer Lending and Mortgage Services portfolios.

Corporate and commercial lending was 46% of gross lending to customers at 31 December 2010, comprising our largest lending category. Commercial, industrial and international trade represented the largest portion of this category and this increased by 23% in the year, reflecting the growth in trade activity, particularly in Asia. Commercial real estate lending, which represented 7% of total gross lending to customers, increased by 5% due to strong growth in Hong Kong.

In the financial category, our largest exposure was to non-bank financial institutions; this largely comprised secured lending on trading accounts, mainly repo facilities.

Loans and advances to banks were widely distributed across major institutions in 2010 and increased by 16% as placements with central and commercial banks in Europe, Asia and Latin America rose.

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.

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Report of the Directors: Operating and Financial Review (continued)*Gross loans and advances by industry sector
(Audited)*

	2010	Currency	Move-	2009	2008	2007	2006
	US\$m	effect	ment	US\$m	US\$m	US\$m	US\$m
		US\$m	US\$m				
Personal ²	425,320	(2,026)	(6,860)	434,206	440,227	500,834	476,146
Residential mortgages ^{2,3}	268,681	(1,707)	9,719	260,669	243,337	269,068	265,337
Other personal ^{2,4}	156,639	(319)	(16,579)	173,537	196,890	231,766	210,809
Corporate and commercial	445,512	(5,297)	67,719	383,090	407,474	400,771	343,107
Commercial, industrial and international trade	237,694	(2,948)	44,514	196,128	209,840	202,038	162,109
Commercial real estate	71,880	(773)	3,264	69,389	70,969	72,345	60,366
Other property-related	34,838	222	4,096	30,520	30,739	33,907	27,165
Government	8,594	(14)	1,919	6,689	6,544	5,708	8,990
Other commercial ⁵	92,506	(1,784)	13,926	80,364	89,382	86,773	84,477
Financial	101,725	(3,540)	8,615	96,650	101,085	99,148	62,458
Non-bank financial institutions	100,163	(3,544)	8,470	95,237	99,536	96,781	59,204
Settlement accounts	1,562	4	145	1,413	1,549	2,367	3,254
Asset-backed securities reclassified	5,892	(319)	(1,616)	7,827	7,991		
Total gross loans and advances to customers (TGLA ⁶)	978,449	(11,182)	67,858	921,773	956,777	1,000,753	881,711
Gross loans and advances to banks	208,429	(8)	28,549	179,888	153,829	237,373	185,212
	1,186,878	(11,190)	96,407	1,101,661	1,110,606	1,238,126	1,066,923

Total gross loans and advances							
Impaired loans and advances to customers	28,091	(254)	(2,261)	30,606	25,352	19,582	15,071
as a percentage of TGLAC	2.9%			3.3%	2.6%	2.0%	1.7%
Impairment allowances on loans and advances to customers	20,083	(75)	(5,384)	25,542	23,909	19,205	13,578
as a percentage of TGLAC	2.1%			2.8%	2.5%	1.9%	1.5%
Charge for impairment losses	13,548	321	(11,715)	24,942	24,131	17,177	10,547
New allowances net of allowance releases	14,568	353	(11,617)	25,832	24,965	18,182	11,326
Recoveries	(1,020)	(32)	(98)	(890)	(834)	(1,005)	(779)

For footnotes, see page 174.

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Report of the Directors: Operating and Financial Review (continued)

*Gross loans and advances to customers by industry sector and by geographical region
(Audited)*

	Gross loans and advances to customers						Total US\$m	As a % of total gross loans %
	Hong Kong US\$m	Rest of Asia- Pacific US\$m	Middle East US\$m	North America US\$m	Latin America US\$m	Europe US\$m		
At 31 December 2010								
Personal	161,717	57,308	40,184	5,371	139,117	21,623	425,320	43.4
Residential mortgages ³	111,618	42,488	28,724	1,751	78,842	5,258	268,681	27.4
Other personal ⁴	50,099	14,820	11,460	3,620	60,275	16,365	156,639	16.0
Corporate and commercial	203,804	80,823	67,247	19,560	38,707	35,371	445,512	45.6
Commercial, industrial and international trade	111,980	33,451	41,274	11,173	16,737	23,079	237,694	24.3
Commercial real estate	30,629	19,678	8,732	1,085	8,768	2,988	71,880	7.3
Other property-related	6,401	15,232	5,426	1,785	5,109	885	34,838	3.6
Government	2,289	2,339	415	1,345	89	2,117	8,594	0.9
Other commercial ⁵	52,505	10,123	11,400	4,172	8,004	6,302	92,506	9.5
Financial	70,725	3,189	2,259	1,347	21,202	3,003	101,725	10.4
Non-bank financial institutions	70,019	2,824	2,058	1,335	21,109	2,818	100,163	10.2
Settlement accounts	706	365	201	12	93	185	1,562	0.2
Asset-backed securities reclassified	5,216				676		5,892	0.6
TGLAC ⁶	441,462	141,320	109,690	26,278	199,702	59,997	978,449	100.0
Percentage of TGLAC by geographical region	45.2%	14.4%	11.2%	2.7%	20.4%	6.1%	100.0%	

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Impaired loans as a percentage of TGLAC	10,557 2.4%	660 0.5%	1,324 1.2%	2,433 9.3%	10,727 5.4%	2,390 4.0%	28,091 2.9%	
Total impairment allowances as a percentage of TGLAC	5,663 1.3%	629 0.4%	959 0.9%	1,652 6.3%	9,170 4.6%	2,010 3.4%	20,083 2.1%	
At 31 December 2009								
Personal	162,562	47,946	32,514	6,405	163,934	20,845	434,206	47.2
Residential mortgages ³	109,872	35,292	21,983	1,898	86,591	5,033	260,669	28.3
Other personal ⁴	52,690	12,654	10,531	4,507	77,343	15,812	173,537	18.9
Corporate and commercial ⁷	202,919	49,340	46,175	16,604	40,902	27,150	383,090	41.5
Commercial, industrial and international trade	112,374	17,728	28,228	9,336	11,528	16,934	196,128	21.3
Commercial real estate	33,853	13,782	6,475	1,309	11,527	2,443	69,389	7.5
Other property-related	6,231	10,062	3,863	1,357	8,452	555	30,520	3.3
Government	2,216	441	595	1,356	208	1,873	6,689	0.7
Other commercial ⁵	48,245	7,327	7,014	3,246	9,187	5,345	80,364	8.7
Financial	73,851	2,899	2,350	1,213	14,150	2,187	96,650	10.5
Non-bank financial institutions	73,225	2,462	2,246	1,206	13,963	2,135	95,237	10.3
Settlement accounts	626	437	104	7	187	52	1,413	0.2
Asset-backed securities reclassified	6,284				1,543		7,827	0.8
TGLAC ⁶	445,616	100,185	81,039	24,222	220,529	50,182	921,773	100.0
Percentage of TGLAC by geographical region	48.3%	10.9%	8.8%	2.6%	23.9%	5.5%	100.0%	
Impaired loans as a percentage of TGLAC	10,722 2.4%	841 0.8%	1,200 1.5%	1,646 6.8%	13,246 6.0%	2,951 5.9%	30,606 3.3%	
Total impairment allowances as a percentage of TGLAC	6,135 1.4%	804 0.8%	996 1.2%	1,378 5.7%	13,676 6.2%	2,553 5.1%	25,542 2.8%	

For footnotes, see page 174.

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*Loans and advances to banks by geographical region
(Audited)*

	Europe US\$m	Hong Kong US\$m	Rest of Asia- Pacific US\$m	Middle East US\$m	North America US\$m	Latin America US\$m	Loans and advances to banks US\$m	Impair- ment allowances US\$m
At 31 December 2010⁸	78,239	33,585	40,437	9,335	19,479	27,354	208,429	(158)
At 31 December 2009	65,614	36,197	35,648	8,435	15,386	18,608	179,888	(107)
At 31 December 2008	62,012	29,646	28,665	7,476	11,458	14,572	153,829	(63)
At 31 December 2007	104,534	63,737	32,373	7,488	16,566	12,675	237,373	(7)
At 31 December 2006	76,837	50,359	19,716	7,801	17,865	12,634	185,212	(7)

*Gross loans and advances to customers by country
(Audited)*

	Residential mortgages US\$m	Other personal US\$m	Property- related US\$m	Commercial, international trade and other US\$m	Total US\$m
At 31 December 2010					
Europe	111,618	50,099	37,030	242,715	441,462
UK	103,037	25,636	26,002	165,283	319,958
France	3,749	9,550	8,737	56,613	78,649
Germany	11	356	79	4,015	4,461
Malta	1,656	599	563	1,643	4,461
Switzerland	1,358	10,708	114	1,837	14,017
Turkey	809	2,817	210	2,783	6,619
Other	998	433	1,325	10,541	13,297
Hong Kong	42,488	14,820	34,910	49,102	141,320
Rest of Asia-Pacific	28,724	11,460	14,158	55,348	109,690
Australia	8,405	1,267	2,346	4,867	16,885
India	920	526	680	4,583	6,709
Indonesia	74	531	115	3,374	4,094
Japan	226	199	1,214	2,503	4,142
Mainland China	2,046	310	3,836	12,932	19,124

Malaysia	3,833	2,053	1,361	4,845	12,092
Singapore	6,571	3,661	3,262	7,846	21,340
South Korea	2,295	248	58	2,494	5,095
Taiwan	3,002	527	135	2,832	6,496
Vietnam	35	162	59	1,255	1,511
Other	1,317	1,976	1,092	7,817	12,202
Middle East (excluding Saudi Arabia)	1,751	3,620	2,870	18,037	26,278
Egypt	3	396	111	2,484	2,994
Qatar	8	491	404	918	1,821
United Arab Emirates	1,477	2,099	1,359	11,043	15,978
Other	263	634	996	3,592	5,485
North America	78,842	60,275	13,877	46,708	199,702
US	57,630	51,686	8,269	31,496	149,081
Canada	19,505	8,070	5,079	14,711	47,365
Bermuda	1,707	519	529	501	3,256
Latin America	5,258	16,365	3,873	34,501	59,997
Argentina	30	918	103	2,172	3,223
Brazil	1,111	10,979	1,816	17,093	30,999
Mexico	2,097	2,365	1,146	8,622	14,230
Panama	1,155	982	489	3,794	6,420
Other	865	1,121	319	2,820	5,125
Total	268,681	156,639	106,718	446,411	978,449

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Report of the Directors: Operating and Financial Review (continued)

	Residential mortgages US\$m	Other personal US\$m	Property- related US\$m	Commercial, international trade and other US\$m	Total US\$m
At 31 December 2009					
Europe	109,872	52,690	40,084	242,970	445,616
UK	100,667	29,018	28,339	175,513	333,537
France	4,326	10,224	9,429	48,570	72,549
Germany	10	404	90	3,689	4,193
Malta	1,730	612	660	1,689	4,691
Switzerland	1,301	9,197	175	1,413	12,086
Turkey	843	2,778	150	2,490	6,261
Other	995	457	1,241	9,606	12,299
Hong Kong	35,292	12,654	23,844	28,395	100,185
Rest of Asia-Pacific	21,983	10,531	10,338	38,187	81,039
Australia	5,919	993	1,785	3,496	12,193
India	883	864	458	3,002	5,207
Indonesia	59	571	71	2,114	2,815
Japan	109	149	796	1,444	2,498
Mainland China	1,503	319	2,633	8,915	13,370
Malaysia	2,925	1,717	1,085	3,548	9,275
Singapore	5,149	3,041	2,407	4,251	14,848
South Korea	2,093	407	30	1,932	4,462
Taiwan	2,205	503	53	1,578	4,339
Vietnam	23	132	51	1,042	1,248
Other	1,115	1,835	969	6,865	10,784
Middle East (excluding Saudi Arabia)	1,898	4,507	2,666	15,151	24,222
Egypt	4	326	126	2,132	2,588
Qatar	9	624	416	841	1,890
United Arab Emirates	1,650	2,881	1,395	8,848	14,774
Other	235	676	729	3,330	4,970

North America	86,591	77,343	19,979	36,616	220,529
US	65,784	69,275	8,922	25,747	169,728
Canada	19,228	7,526	10,641	10,339	47,734
Bermuda	1,579	542	416	530	3,067
Latin America	5,033	15,812	2,998	26,339	50,182
Argentina	31	628	49	1,689	2,397
Brazil	717	10,494	1,076	12,111	24,398
Mexico	2,259	2,702	995	6,762	12,718
Panama	1,151	973	475	3,464	6,063
Other	875	1,015	403	2,313	4,606
Total	260,669	173,537	99,909	387,658	921,773

Country distribution of outstandings and cross-border exposures

(Unaudited)

We control the risk associated with cross-border lending through a centralised structure of internal country limits. Exposures to individual countries and cross-border exposure in the 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 0.75% of our 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, certificates of deposit (CDs) and debt and equity securities (net of short positions), and exclude accrued interest and intra-HSBC exposures.

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*In-country foreign currency and cross-border amounts outstanding
(Unaudited)*

	Banks US\$bn	Government and official institutions US\$bn	Other US\$bn	Total US\$bn
At 31 December 2010				
UK	27.6	6.3	51.6	85.5
US	13.6	37.6	17.6	68.8
France	23.8	11.1	11.2	46.1
Hong Kong	15.4	1.6	17.2	34.2
Mainland China	21.5	1.2	9.1	31.8
Japan	14.0	16.2	1.3	31.5
Germany	17.8	4.2	9.4	31.4
At 31 December 2009				
UK	37.5	7.0	38.0	82.5
US	10.7	29.3	25.7	65.7
France	27.0	10.7	7.7	45.4
Germany	21.9	15.0	4.5	41.4
The Netherlands ⁹	10.3	1.7	7.6	19.6
At 31 December 2008				
UK	38.4	7.1	33.8	79.3
US	13.6	26.4	34.1	74.1
France	19.9	12.1	7.9	39.9
Germany	18.9	8.0	6.7	33.6
The Netherlands	14.1	1.9	10.3	26.3
Japan ⁹	2.6	19.4	2.3	24.3

For footnote, see page 174.

Areas of special interest

Wholesale lending

(Unaudited)

Wholesale lending covers the range of credit facilities granted to sovereign borrowers, banks, non-bank financial institutions and corporate entities. Our wholesale portfolios are well diversified across geographical and industry sectors, with certain exposures subject to specific portfolio controls. Overall credit quality improved during 2010, as economies generally demonstrated signs of recovery.

Exposures to countries in the eurozone*(Unaudited)*

Intervention by governments to stabilise and re-capitalise banks and other financial intermediaries during the financial crisis helped to reduce the possibility of a systemic threat to financial markets by transferring risk from the private sector to sovereign bodies. In 2010, this contributed to the creation of large fiscal imbalances in some industrialised

economies and as a result, market concerns about sovereign credit risk in these countries intensified. Credit spreads for the affected sovereign and bank credit markets remained volatile during most of 2010. Risk aversion resurfaced, and the assumption of higher sovereign credit risk premia in private securities prices triggered portfolio reallocation to safer assets and a tightening of market liquidity. Initial concerns over liquidity and funding spread to doubts about solvency in a number of cases. The table below summarises our exposures to governments and central banks of selected eurozone countries, and near/quasi government agencies and banks domiciled in those countries. An analysis of loans and advances to customers by significant countries is provided on page 101.

Our exposure to eurozone countries under pressure in 2010 was US\$25.4bn.

Sovereign debt

As a result of the disruption in global financial markets, the eurozone experienced a severe recession, followed by a sovereign debt crisis in some member countries, where the high level of government deficits, banking system problems, fiscal imbalances and low or declining GDP growth increased their perceived vulnerability to a future downturn. Various financial and political stresses forced Greece and Ireland to seek a bailout by the ECB and the International Monetary Fund (IMF) in May and November 2010, respectively, and contagion risk to peripheral countries, notably Italy, Portugal and Spain persisted. Belgium was also

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Exposures to selected eurozone countries¹⁰
(Unaudited)

	At 31 December 2010						
	Not held for trading			Held for trading			
	Cash and lending to banks ¹¹ US\$bn	Financial investments US\$bn	Total balances US\$bn	Net debt securities and loans US\$bn	Derivatives ¹² US\$bn	Total balances US\$bn	Total US\$bn
Belgium							
Sovereign and agencies	0.2	0.7	0.9	0.6		0.6	1.5
Banks	5.8	0.3	6.1	1.5	1.2	2.7	8.8
	6.0	1.0	7.0	2.1	1.2	3.3	10.3
Greece							
Sovereign and agencies		0.3	0.3	0.8		0.8	1.1
Banks				0.6		0.6	0.6
		0.3	0.3	1.4		1.4	1.7
Ireland							
Sovereign and agencies		0.2	0.2	0.1	0.1	0.2	0.4
Banks	0.2	0.5	0.7	1.1	0.4	1.5	2.2
	0.2	0.7	0.9	1.2	0.5	1.7	2.6
Italy							
Sovereign and agencies		1.7	1.7	1.8		1.8	3.5
Banks	1.9	0.4	2.3	0.2		0.2	2.5
	1.9	2.1	4.0	2.0		2.0	6.0

Portugal							
Sovereign and agencies		0.1	0.1				0.1
Banks	0.3	0.1	0.4	0.1		0.1	0.5
	0.3	0.2	0.5	0.1		0.1	0.6
Spain							
Sovereign and agencies	0.1	0.9	1.0	0.7	0.1	0.8	1.8
Banks	0.8	0.2	1.0	1.4		1.4	2.4
	0.9	1.1	2.0	2.1	0.1	2.2	4.2
Total							
Sovereign and agencies	0.3	3.9	4.2	4.0	0.2	4.2	8.4
Banks	9.0	1.5	10.5	4.9	1.6	6.5	17.0
	9.3	5.4	14.7	8.9	1.8	10.7	25.4

For footnotes, see page 174.

under pressure, but for its specific political situation. Rating agencies downgraded the debt of a number of eurozone countries during 2010 and put some on review for possible downgrades. While the ECB continues to provide broad access to liquidity support for eurozone sovereign borrowers and banks, the availability of longer-term fiscal support from the EU for sovereigns is less certain and may lead to debt restructuring and increased private sector participation.

The eurozone as a whole retained substantial economic and financial strength despite the stresses from the financial crisis. However, concerns remained over the refinancing risks for sovereign borrowers and banks posed by the problems with market liquidity and the uncertainty surrounding support arrangements in the longer term. Eurozone policymakers have created two major facilities to counter short-term financing problems, the European Financial Stability Facility and the European Financial Stability Mechanism. This has been viewed as a positive development by the market and rating agencies, though implementation awaits disclosure of further details by the policymakers. We expect the ECB and eurozone countries will focus in 2011 on resolving intra-eurozone imbalances, rebuilding public finances, improving fiscal discipline, strengthening the banking system and managing cross-border risk.

We have closely managed our exposure to sovereign debt during 2010. At the end of the year, our exposure to the sovereign debt of Belgium, Greece, Ireland, Italy, Portugal and Spain was US\$8.4bn and the overall quality of the portfolio was strong with most in-country and cross-border limits extended to countries with high-grade internal credit risk ratings. We regularly update our assessment of higher risk countries and adjust our risk appetite to reflect such changes.

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European banks