

HSBC HOLDINGS PLC
Form 20-F
March 09, 2007

As filed with the Securities and Exchange Commission on March 9, 2007.

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 20-F

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

or

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934 For the fiscal year ended December 31, 2006

or

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

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

Commission file number: 1-14930

HSBC Holdings plc

(Exact name of Registrant as specified in its charter)

N/A

(Translation of Registrant's name into English)

United Kingdom

(Jurisdiction of incorporation or organisation)

8 Canada Square

London E14 5HQ

United Kingdom

(Address of principal executive offices)

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

<u>Title of each class</u>	<u>Name of each exchange on which registered</u>
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.	New York Stock Exchange* New York Stock Exchange
6.20% Non-Cumulative Dollar Preference Shares, Series A	New York Stock Exchange*
American Depositary Shares, each representing one-fortieth of a Share of 6.20% Non-Cumulative Dollar Preference Shares, Series A	New York Stock Exchange
5.25% Subordinated Notes 2012	New York Stock Exchange

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6.5% Subordinated Notes 2036
New York Stock Exchange
Securities registered or to be registered pursuant to Section 12(g) of the Securities Exchange Act of 1934: None

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

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

Ordinary Shares, nominal value US\$0.50 each 11,333,603,942

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes

No

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

Yes

No

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

Yes

No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Indicate by check mark which 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 2006

Headquartered in London, HSBC is one of the largest banking and financial services organisations in the world. Its international network comprises over 10,000 properties in 82 countries and territories in Europe; Hong Kong; Rest of Asia-Pacific, including the Middle East and Africa; North America and Latin America.

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

HSBC provides a comprehensive range of financial services to more than 125 million customers through four customer groups and global businesses: Personal Financial Services (including consumer finance); Commercial Banking; Corporate, Investment Banking and Markets; and Private Banking.

Contents

	<i>Page</i>
<u>Financial Highlights</u>	<u>1</u>
<u>Cautionary Statement Regarding Forward-Looking Statements</u>	<u>4</u>
<u>Report of the Directors</u>	<u>6</u>
<u>Business Review</u>	<u>6</u>
<u>Financial Review</u>	<u>110</u>
<u>The Management of Risk</u>	<u>165</u>
<u>Governance</u>	<u>248</u>
<u>Directors' Remuneration Report</u>	<u>280</u>
	<i>Page</i>
<u>Statement of Directors' Responsibilities in Relation to Financial Statements</u>	<u>290</u>
<u>Independent Auditor's Report</u>	<u>291</u>
<u>Financial Statements</u>	<u>293</u>
<u>Notes on the Financial Statements</u>	<u>301</u>
<u>Shareholder Information</u>	<u>435</u>
<u>Glossary and Index</u>	<u>447</u>

Certain defined terms

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

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

[Back to Contents](#)

HSBC HOLDINGS PLC

Financial Highlights

For the year

- Total operating income up 13.6 per cent to US\$70,070 million (2005: US\$61,704 million).
- Net operating income up 9.9 per cent to US\$54,793 million (2005: US\$49,836 million).
- Group pre-tax profit up 5.3 per cent to US\$22,086 million (2005: US\$20,966 million).
- Profit attributable to shareholders of the parent company up 4.7 per cent to US\$15,789 million (2005: US\$15,081 million).
- Return on average invested capital of 14.9 per cent (2005: 15.9 per cent).
- Earnings per share up 2.9 per cent to US\$1.40 (2005: US\$1.36).

At the year-end

- Total equity up 17.0 per cent to US\$114,928 million (2005: US\$98,226 million).
- Customer accounts and deposits by banks up 23.2 per cent to US\$996,528 million (2005: US\$809,146 million).
- Risk-weighted assets up 13.5 per cent to US\$938,678 million (2005: US\$827,164 million).

Dividends and capital position

- Tier 1 capital ratio of 9.4 per cent and total capital ratio of 13.5 per cent.
- Fourth interim dividend for 2006 of US\$0.36 per share, an increase of 16.1 per cent; total dividends declared in 2006 of US\$0.76 per share, an increase of 10.1 per cent over 2005.

Data for 2004 to 2006 are presented based on financial statements prepared in accordance with IFRSs; data for 2002 and 2003 in accordance with UK GAAP. Further information about the results is given in the consolidated income statement on page 294

[Back to Contents](#)

HSBC HOLDINGS PLC

Financial Highlights (continued)

Ratios / 5-year comparison

Capital and performance ratios

	2006	2005
	%	%
Capital ratios		
Tier 1 capital	9.4	9.0
Total capital	13.5	12.8

Performance ratios

Return on average invested capital ¹	14.9	15.9
Return on average total shareholders' equity ²	15.7	16.8
Post-tax return on average total assets	1.00	1.06
Post-tax return on average risk-weighted assets	1.93	2.01

Credit coverage ratios

Loan impairment charges as a percentage of total operating income	15.05	12.74
Loan impairment charges as a percentage of average gross customer advances	1.39	1.16
Total impairment allowances outstanding as a percentage of impaired loans at the year-end	98.5	99.1

Efficiency and revenue mix ratios

Cost efficiency ratio ³	51.3	51.2
□ constant currency basis	51.3	51.3
As a percentage of total operating income:		
□ net interest income	49.2	50.8
□ net fee income	24.5	23.4
□ trading income	11.7	9.5

Financial ratio

Average total shareholders' equity to average total assets	5.97	5.96
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Share information at the year-end

	2006	2005
US\$0.50 ordinary shares in issue (million)	11,572	11,334
Market capitalisation (billion)	US\$212	US\$182
Closing market price per ordinary share:		
□ London	£9.31	£9.33
□ Hong Kong	HK\$142.40	HK\$124.50
Closing market price per American Depositary Share ⁴	US\$91.65	US\$80.47

Over 1 year	Over 3 years	Over 5 years
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HSBC total shareholder return to 31 December 2006 ⁵	104.6	122.0	148.4
Benchmarks:			
□ FTSE 100	114.4	153.8	141.1
□ MSCI World	105.8	139.9	122.4

For footnotes, see page 4.

The consolidated financial statements of HSBC and the separate financial statements of HSBC Holdings have been prepared in accordance with International Financial Reporting Standards (□IFRSs□) as endorsed by the EU. EU-endorsed IFRSs may differ from IFRSs as published by the International Accounting Standards Board (□IASB□) if, at any point in time, new or amended IFRSs have not been endorsed by the EU. At 31 December 2006, there were no unendorsed standards effective for the year ended 31 December 2006 affecting these consolidated and separate financial statements, and there was no difference in application to HSBC between IFRSs endorsed by the EU and IFRSs issued by the IASB.

Information for the years prior to 2004 has been prepared under previous HSBC policies in accordance with UK Generally Accepted Accounting Principles (□UK GAAP□), which are not comparable with IFRSs.

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

When reference to □underlying basis□ is made in commentaries, comparative information has been expressed at constant currency (see page 110) and adjusted for the effects of acquisitions, disposals and the change in presentation of non-equity minority interests.

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

	Amounts in accordance with IFRSs ⁸			Amounts in accordance with UK GAAP ⁹	
	2006 US\$m	2005 US\$m	2004 US\$m	2003 US\$m	2002 US\$m
For the year					
Net interest income	34,486	31,334	31,099	25,598	15,460
Other operating income	35,584	30,370	24,889	15,474	11,135
Loan impairment charges and other credit risk provisions	(10,573)	(7,801)	(6,191)	□	□
Provisions for bad and doubtful debts	□	□	□	(6,093)	(1,321)
Total operating expenses	(33,553)	(29,514)	(26,487)	(22,532)	(15,808)
Profit before tax	22,086	20,966	18,943	12,816	9,650
Profit attributable to shareholders of the parent company	15,789	15,081	12,918	8,774	6,239
Dividends	8,769	7,750	6,932	6,532	5,001
At the year-end					
Called up share capital	5,786	5,667	5,587	5,481	4,741
Total shareholders' equity	108,352	92,432	85,522	□	□
Shareholders' funds	□	□	□	74,473	51,765
Capital resources ¹⁰	127,074	105,449	90,780	74,042	57,430
Customer accounts	896,834	739,419	693,072	573,130	495,438
Undated subordinated loan capital	3,219	3,474	3,686	3,617	3,540
Preferred securities and date dsubordinated loan capital ¹¹	42,642	35,856	32,914	17,580	14,831
Loans and advances to customers ^{12,13}	868,133	740,002	672,891	528,977	352,344
Total assets	1,860,758	1,501,970	1,279,974	1,034,216	758,605
	US\$	US\$	US\$	US\$	US\$
Per ordinary share					
Basic earnings	1.40	1.36	1.18	0.84	0.67
Diluted earnings	1.39	1.35	1.17	0.83	0.66
Dividends ¹⁴	0.76	0.69	0.63	0.60	0.53
Net asset value at year-end	9.24	8.03	7.66	6.79	5.46
Share information					
US\$0.50 ordinary shares in issue (millions)	11,572	11,334	11,172	10,960	9,481
	%	%	%	%	%
Financial ratios					
Dividend payout ratio ¹⁵	54.3	50.7	53.4	60.6	69.7
Post-tax return on average total assets	1.00	1.06	1.14	1.01	0.97
Return on average total shareholders' equity	15.7	16.8	16.3	□	□
Return on average shareholders' funds	□	□	□	13.0	12.4
Average total shareholders' equity to average total assets	5.97	5.96	6.35	□	□
Average shareholders' funds to average total assets	□	□	□	7.06	6.91
Capital ratios					
Tier 1 capital	9.4	9.0	8.9	8.9	9.0
Total capital	13.5	12.8	12.0	12.0	13.3

Foreign exchange translation rates to

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US\$						
Closing	□ £:US\$1	0.509	0.581	0.517	0.560	0.620
	□ □:US\$1	0.759	0.847	0.733	0.793	0.953
Average	□ £:US\$1	0.543	0.550	0.546	0.612	0.666
	□ □:US\$1	0.797	0.805	0.805	0.885	1.061

For footnotes, see page 4.

[Back to Contents](#)

HSBC HOLDINGS PLC

Financial Highlights (continued)

5-year comparison / Cautionary statement

Amounts in accordance with US GAAP

	2006	2005	2004	2003	2002
	US\$m	US\$m	US\$m	US\$m	US\$m
Income statement for the year					
Net income available for ordinary shareholders	16,358	14,703	12,506	7,231	4,900
Other comprehensive income	3,133	(7,271)	983	7,401	5,502
Dividends	8,769	7,750	6,932	6,974	4,632

Balance sheet at 31 December

Total assets	1,712,627	1,406,944	1,266,365	1,012,023	763,565
Total shareholders' equity	108,540	93,524	90,082	80,251	55,831

	US\$	US\$	US\$	US\$	US\$
Per ordinary share					
Basic earnings	1.45	1.33	1.15	0.69	0.52
Diluted earnings	1.44	1.32	1.13	0.69	0.52
Dividends	0.76	0.69	0.63	0.685	0.495
Net asset value at year end	9.38	8.25	8.06	7.32	5.89

Footnotes to Financial Highlights

- The definition of return on average invested capital and a reconciliation to the equivalent GAAP measures are set out on page 146.
- The return on average total shareholders' equity is defined as profit attributable to shareholders of the parent company divided by average total shareholders' equity.
- The cost efficiency ratio is defined as total operating expenses divided by net operating income before loan impairment charges and other credit risk provisions.
- Each American Depositary Share (ADS) represents five ordinary shares.
- Total shareholder return (TSR) is defined on page 281.
- The Financial Times-Stock Exchange 100 Index.
- The Morgan Stanley Capital International World Index.
- Comparative data for 2004 excludes the provisions of IAS 32, IAS 39 and IFRS 4, which were adopted for the first time with effect from 1 January 2005.
- The periods 2002 and 2003 were prepared in accordance with previous HSBC accounting policies under UK GAAP. HSBC's accounting policies under UK GAAP are stated in Note 2 on the Financial Statements in the Annual Report and Accounts 2004.
- Capital resources are total regulatory capital, the calculation of which is set out on page 243.
- Includes perpetual preferred securities, details of which can be found in Note 32 on the Financial Statements.
- Net of suspended interest and provisions for bad and doubtful debts (UK GAAP).
- Net of impairment allowances (IFRSs).
- First, second and third interim dividends for 2006, each of US\$0.15 per ordinary share, were paid on 6 July 2006, 4 October 2006 and 18 January 2007 respectively. Note 11 on the Financial Statements on page 339 gives more information on the dividends declared in 2006. On 5 March 2007, the Directors declared a fourth interim dividend for 2006 of US\$0.36 per ordinary share in lieu of a final dividend, which will be payable to ordinary shareholders on 10 May 2007 in cash in US dollars, or in sterling or Hong Kong dollars at exchange rates to be determined on 30 April 2007, with a scrip dividend alternative. The reserves available for

distribution at 31 December 2006 were US\$12,045 million.

Quarterly dividends of US\$15.50 per 6.20 per cent non-cumulative US dollar preference share, Series A (Series A dollar preference share), equivalent to a dividend of US\$0.3875 per Series A American Depositary Shares, each of which represents one-fortieth of a Series A dollar preference share, were paid on 15 March 2006, 15 June 2006, 15 September 2006 and 15 December 2006.

15 Dividends per share expressed as a percentage of earnings per share (2002 and 2003: excluding goodwill amortisation).

Cautionary Statement Regarding Forward-Looking Statements

The *Annual Report and Accounts 2006* contains certain forward-looking statements with respect to the financial condition, results of operations and business of HSBC.

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

expressions are intended to identify forward-looking statements. These statements are based on current plans, estimates and projections, and therefore undue reliance should not be placed on them. Forward-looking statements speak only as of the date they are made, and it should not be assumed that they have been revised or updated in the light of new information or future events.

Written and/or oral forward-looking statements may also be made in the periodic reports to the

[Back to Contents](#)

United States Securities and Exchange Commission, summary financial statements to shareholders, proxy statements, offering circulars and prospectuses, press releases and other written materials, and in oral statements made by HSBC's Directors, officers or employees to third parties, including financial analysts.

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

- changes in general economic conditions in the markets in which HSBC operates, such as:
 - changes in foreign exchange rates, in both market exchange rates (for example, between the US dollar and pound sterling) and government-established exchange rates (for example, between the Hong Kong dollar and US dollar);
 - volatility in interest rates;
 - volatility in equity markets, including in the smaller and less liquid trading markets in Asia and South America;
 - lack of liquidity in wholesale funding markets in periods of economic or political crisis;
 - illiquidity and downward price pressure in national real estate markets, particularly consumer-owned real estate markets;
 - the impact of lower than expected investment returns on the funding of private and public sector defined benefit pensions;
 - the effect of unexpected changes in actuarial assumptions on longevity which would influence the funding of private and public sector defined benefit pensions;
 - continuing or deepening recessions and employment fluctuations; and
 - consumer perception as to the continuing availability of credit, and price competition in the market segments served by HSBC.
- changes in governmental policy and regulation, including:
 - the monetary, interest rate and other policies of central banks and other regulatory authorities, including the UK Financial Services Authority, the Bank of England, the Hong Kong Monetary Authority, the US Federal Reserve, the US Securities and Exchange Commission, the US Office of the Comptroller of the Currency, the European Central Bank, the People's Bank of China and the central banks of other leading economies and markets where HSBC operates;
 - expropriation, nationalisation, confiscation of assets and changes in legislation relating to foreign ownership;
 - initiatives by local, state and national regulatory agencies or legislative bodies to revise the practices, pricing or responsibilities of financial institutions serving their consumer markets;
 - changes in bankruptcy legislation in the principal markets in which HSBC operates and the consequences thereof;
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general changes in governmental policy that may significantly influence investor decisions, in particular markets in which HSBC operates;

- other unfavourable political or diplomatic developments producing social instability or legal uncertainty which in turn may affect demand for HSBC's products and services;
 - the costs, effects and outcomes of regulatory reviews, actions or litigation, including any additional compliance requirements; and
 - the effects of competition in the markets where HSBC operates including increased competition from non-bank financial services companies, including securities firms.
- factors specific to HSBC:
 - the success of HSBC in adequately identifying the risks it faces, such as the incidence of loan losses or delinquency, and managing those risks (through account management, hedging and other techniques). Effective risk management depends on, among other things, HSBC's ability through stress testing and other techniques to prepare for events that cannot be captured by the statistical models it uses.

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Business Review

Group Chairman's statement

Group Chairman's statement

It is a testament to HSBC's strength and diversity that we grew pre-tax profits in 2006 to US\$22 billion, despite a major setback in part of our mortgage business in the United States. For the third year running, return on average shareholders equity exceeded 15 per cent, revenue growth was in double digits and we maintained an essentially flat cost-efficiency ratio. In 2006, pre-tax profits from Asia, the Middle East, Latin America and other emerging markets approached 50 per cent of the Group's total.

There were a number of outstanding achievements, for example, exceeding US\$1 billion pre-tax profits for the first time in both Mexico and the Middle East, and in each of our Private Banking and Commercial Banking businesses in Asia outside Hong Kong. We added around an extra US\$1 billion of pre-tax profits in Asia outside Hong Kong and another US\$1 billion in our Commercial Banking businesses worldwide. In Hong Kong, net fee income from personal customers grew over 30 per cent to approach US\$1 billion for the first time.

However, our pre-tax profits fell by US\$725 million in our personal businesses in the United States. This was caused by one portfolio of purchased sub-prime mortgages in our US Consumer Finance subsidiary, Mortgage Services, which evidenced much higher delinquency than had been built into the pricing of these products. We are restructuring this business to avoid any repetition of the risk concentration that built up over the past two years. As part of this exercise we have effected broad changes in management and strengthened risk controls and processes.

Despite the issues in our US mortgage business, Group profit attributable to shareholders grew by 5 per cent to US\$15,789 million. We met our

objective of funding organic expansion through productivity improvements. To achieve this in a year of continuing investment in developing our distribution platforms and product capabilities is a tribute to the focus which HSBC's 312,000 staff around the world have placed on serving our customers.

Earnings continued to be well diversified both geographically and by customer group. Regionally, Asia, including Hong Kong, had record results as did our newly designated Latin American Region, which combines Mexico and Central America with our South American businesses. Within our customer groups, Commercial Banking again delivered a record performance, as did Private Banking and Corporate, Investment Banking and Markets, which made strong progress in the areas in which we have been investing in recent years. Personal Financial Services profits declined as growth in Asia and Latin America was masked by the problems in the US Mortgage Services business.

The Board has declared a fourth interim dividend of US\$0.36 per share, taking the total dividend in respect of 2006 to US\$0.81 per share, an increase of 11 per cent over the comparable payout last year. In sterling terms, dividend growth is 5 per cent. The fourth interim dividend is payable on 10 May 2007 to shareholders on the register on 23 March 2007 with a scrip dividend alternative available for shareholders who prefer this option.

Global economic trends and their impact on HSBC

Globalisation is determining how we think about positioning HSBC to take advantage of the changing pattern of economic flows. Historical patterns based on national boundaries are becoming less relevant. In aggregate, our

operations within countries designated as emerging markets grew by 19 per cent in 2006, the third year running of high double-digit growth. However, this understates the importance of emerging markets to HSBC, as their influence is also significant to the results of our operations in developed economies. This reflects the growth in export flows to meet the infrastructure development needs of emerging markets and the reorganisation of global supply chains to optimise international resourcing. HSBC is strongly positioned to benefit from these trends. HSBC seeks to differentiate itself by taking developed market opportunities to emerging market customers and bringing emerging market products to developed investment markets. For example:

[Back to Contents](#)

- In Commercial Banking, we launched a new customer referral system, which led to international referrals with an aggregate facility value of US\$3 billion, involving over 50 sites and 4,000 relationship managers.
- Within Group Investment Businesses, the Group's India, China and BRIC (Brazil, Russia, India, China) funds were major contributors to a record performance in the year as we leveraged our reputation for emerging market expertise to become a major distributor as well as manager of such funds. Performance fees reached record levels.
- In the UK, the Passport bank account provides individuals newly arrived in the UK with discounted remittance services back home together with guidance on establishing themselves in the UK.
- Corporate, Investment Banking and Markets strategy to be a leading wholesale bank by focusing on financing and emerging markets was recognised by industry awards including European Loan House of the Year, China Loan House of the Year and Asian Domestic Currency Bond House of the Year by *International Financing Review*. Our Global Markets business was named Best at Treasury and Risk Management in Asia by *Euromoney* for the ninth consecutive year.

Leveraging our global services

HSBC continued to deepen its relevance to its customer base by offering coordinated services on a worldwide scale. As the globalisation of business increasingly becomes the norm, international capabilities become more and more critical to an ever wider range of customers. We responded to this trend by developing our business in a number of ways.

Benefiting from growing international trade, the Group's payments and cash management business had a record year, particularly in Asia, as increasing numbers of commercial customers expanded internationally.

As emerging market stock exchanges outperformed, the Group's custody businesses benefited from the higher volumes and value flowing into emerging market equities. HSBC retained its position as the leading sub-custodian in Asia and the Middle East, being ranked first in 19 of the 28 markets it serves. Growth in both assets under custody and assets under administration exceeded 25 per cent, as interest in emerging market equities

increased and the alternative fund management sector expanded.

The customer base of International *Premier*, the Group's personal banking service targeted at affluent customers with financial needs in more than one country, grew by 35 per cent to reach 1.8 million. We see great opportunities to develop this service further.

Cross-border distribution was a noteworthy feature of many HSBC-led debt capital market and equity capital market transactions. Highlights included: America Movil's 8 billion Mexican peso bond, Khazanah Nasional of Malaysia's US\$750 million Islamic exchangeable [Sukuk]; Emaar Economic City's US\$680 million IPO in Saudi Arabia; and Shui On Land's US\$876 million IPO in Hong Kong.

Transferring best practice

HSBC seeks to transfer best practice and product innovation internationally. Through such linkages, HSBC is able to achieve both cost efficiency and speed to market, giving us competitive advantages over purely domestic or regional peers. In 2006, we launched a number of successful initiatives.

Using Group technology and marketing expertise, we expanded the Group's card base in Asia by some 1.9 million to 11.9 million. In addition, Bank of Communications' cards business in mainland China, with which we cooperate, reached over 2 million cards in issue at the end of the year from its launch in May 2005.

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Also in mainland China, we cooperated with Bank of Communications in launching point of sale finance in partnership with Wal-Mart and SuNing, one of China's largest consumer electronics chain. In Argentina, our relationship with C&A added 100,000 cards, while in Australia we entered the retail storecard market and now offer point of sale finance in over 1,000 locations through over 100 merchants.

We took the successful direct retail deposit service introduced in the US at the end of 2005 and used the experience to launch in Taiwan in September 2006. In the first 15 weeks, over 24,000 customers had signed up for the service and US\$182 million had been raised in deposits. In the US, by the end of 2006, the direct deposit product had raised some US\$7 billion of funding for our businesses there.

Building on our experience of Takaful (Islamic insurance) in Singapore and United Arab Emirates, we were among the first to be awarded licences to

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Business Review

(continued)

Group Chairman's statement

conduct Takaful business in both Malaysia and Saudi Arabia during 2006.

Creating advantage from scale, technology and process engineering

We continue to make progress in streamlining our operations by focusing on straight through processing and simplifying our products.

During 2006, among other things, we introduced 2,300 advanced self-service terminals, added 13 countries to HSBCnet, which is our strategic internet platform for corporate and institutional clients and made over 900,000 online insurance sales.

HSBC in Mexico was the first bank to offer pre-approved online mortgages in 2006, allowing customers to apply and obtain details about amounts, duration and monthly payments within minutes.

In Hong Kong in the past four years, processing has been moved from the branches in favour of sales-related activities, with the result that less than 5 per cent of transactions are now being handled physically in the branches.

In the UK retail network, product simplification has reduced the range of products by two-thirds over the last two years which, together with branch relocation and refurbishment and adopting retail store hours, is having a positive impact on sales volumes.

Credit environment

The global credit environment, particularly in the corporate and commercial segments, remained generally favourable throughout 2006. In part, this continued to reflect a general abundance of liquidity and the prevalence of historically low nominal interest rates. A significant proportion of the trade surpluses of the major Asian exporting countries and the oil producers continued to be recycled into government debt in developed markets.

Consequently, risk premia remained at record low levels. This encouraged increasing interest in structured products and the acceptance of greater leverage as fixed income investors sought higher yielding assets. The risks arising from this activity were widely distributed using a range of market techniques.

The major credit issue affecting the Group in 2006 arose in the US in the sub-prime mortgage market. A slowdown in the rate of growth in US house prices accelerated delinquency trends in the US sub-prime mortgage market. Deterioration was

marked in the more recent loans, as the absence of equity appreciation reduced customers' options for refinancing. Reduced refinancing options also highlighted the fact that, as adjustable rate mortgages reset over the next few years at higher interest rates than their original rates, the effect of the greater contractual payment obligations will lead to further delinquency.

We took these factors into account in determining the appropriate level of impairment allowances at 31 December 2006 against the Mortgage Services loan book. We factored into our allowances the most recent trends in delinquency and loss severity and estimated the effect of the higher payments due on adjustable rate mortgages as they reset, in particular where we hold a second lien mortgage behind an adjusting first mortgage. Going forward, the level of future impairment allowances will be sensitive to economic conditions and, in particular, to the state of the housing market, the level of interest rates and the availability of financing options for sub-prime borrowers.

Elsewhere in consumer finance in the US, the delinquency rate rose during the year, in large part due to the unusually low levels of delinquency at the end of 2005. This resulted from the effect of changes in bankruptcy law in the fourth quarter of 2005, portfolio ageing and the mix of the Metris portfolio acquired at the end of that year.

In UK Personal Financial Services, loan impairment charges as a percentage of lending remained broadly in line with last year, as actions taken on underwriting and collections mitigated the increasing trend of indebted customers to seek recourse in debt management services. Similarly, in Taiwan, measures taken to deal with the effect of mandatory regulatory relief from credit card debt, which increased impairment charges in the first half of 2006, reduced the charge in the second half of the year.

In the context of HSBC's financial strength and operating profitability, the areas of current weakness are well covered and they will not restrict our ability to develop our business opportunities as planned, or maintain our progressive dividend policy. They have, however, brought additional focus on the uncertain longevity of today's generally benign conditions and on the credit risks inherent in economies where asset prices are accelerating ahead of real wage rises and cash flows are being leveraged using financial products designed to support higher levels of debt. We will ensure that our credit appetite reflects these risks.

[Back to Contents](#)

Group Strategy

As noted above, in 2006, pre-tax profits from Asia, the Middle East, Latin America and other emerging markets approached 50 per cent of the Group's total. We intend the contribution from these markets to trend upwards over the next five years. These economies are growing faster than developed markets and, therefore, we will concentrate investment primarily in these markets in the form of both organic development and acquisition.

During 2006, we brought together our businesses in Latin America into a single management framework to provide clarity and consistency of direction for this important region. Hong Kong and mainland China are already managed on a combined basis, reflecting the fact that this is increasingly a seamless business.

In mature markets, we will focus particularly on serving customers with international financial needs and connectivity, including the diaspora from emerging markets. In an increasingly competitive world, we will enforce tight cost control and will re-engineer or dispose of businesses that dilute our return on capital or do not fit with our core strategy. Insurance and retirement services will be a growing part of our business.

To deliver our strategy, we have articulated seven "global pillars" – the actions we will take to build a financial services company based on the concept of recommendation, both as a place to work and a place to do business. Michael Geoghegan, Group CEO and the senior management team are leading this.

We will remain a broad-based universal bank, with four strategic businesses:

- **Personal Financial Services**, within which consumer finance will remain a core competence;
- **Corporate, Investment Banking and Markets**, which will be a leading wholesale bank by focusing on financing and emerging markets;
- **Commercial Banking**, for which our international service capabilities and connectivity provide a unique competitive platform; and
- **Private Banking**, with its broad international network and connectivity with the rest of the Group's businesses.

These businesses will be increasingly interconnected. In particular, as derivatives markets

expand in product breadth and liquidity and as more risk is securitised globally, our Global Markets business will take a central role in the efficient management of HSBC's capital, risk and related profitability.

Investments in franchise development

In November 2006, we completed the acquisition of Grupo Banistmo S.A., the leading Central American banking group, adding operations in Panama, Colombia, Costa Rica, El Salvador, Honduras and Nicaragua to our existing operations in Mexico, Brazil, Argentina, Uruguay, Chile and Paraguay. HSBC is now one of the leading foreign banks in Latin America. Apart from Banistmo, 2006 was a year of only modest acquisition activity. Very few of the opportunities we examined met our hurdle rates.

Subsequent to the end of the year, we announced our intention to acquire, when regulations permit, a further 10 per cent stake in Techcombank, the third largest joint stock bank in Vietnam, taking our ownership interest to 20 per cent as rules are relaxed to make higher levels of foreign ownership possible.

Organic investment

In 2006 in China, where we are the largest international bank, we opened 13 new offices, taking the total to 45. We made significant progress in developing our personal and commercial distribution platforms throughout Asia, the Middle East and Latin America. We added 25 consumer finance offices in India and 28 in Indonesia. We

established a further 38 branches in Turkey and 3 in Malaysia. In Mexico our continuing development of our business added 2,000 new jobs, bringing the total of new jobs created since we acquired Bital to 8,000. We have also continued to invest in and improve our physical infrastructure in Mexico, with 372 ATMs added in 2006, bringing the total number to over 5,400.

The beginning of 2007 has been marked by our application to incorporate our operations in mainland China after 141 years of unbroken presence in the country. Today, HSBC offers renminbi deposit services in nine cities: Beijing, Dalian, Guangzhou, Qingdao, Shanghai, Shenzhen, Tianjin, Wuhan and Xiamen. The provision of diversified and international banking services to mainland Chinese citizens constitutes one of the most significant growth opportunities for HSBC in the near and long-term and we will support this opportunity with capital and technology resources as required.

Increasingly important to our ongoing success is our brand. Starting in 2007 we will progressively invest more to support and enhance the customer

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Business Review

(continued)

Group Chairman's statement / Principal activities / Strategic direction

experience that drives the brand's strength.

The Board

It is important to HSBC to continue to ensure that the Board is representative of the Group's broad international franchise and the diversity of our businesses. As usual, there will be changes to the make-up of the Board in 2007. As previously announced, as part of planned succession, Simon Robertson will become Senior Independent non-executive Director, Rona Fairhead will become Chairman of the Group Audit Committee and Sir Brian Williamson will become Chairman of the Nomination Committee at the conclusion of this year's AGM. Raymond Chien, Sharon Hintze and Helmut Sohmen will all retire at the 2007 AGM after many years distinguished service. I thank them all for their counsel and guidance.

Outlook

Although growth expectations in the US are moderating, the economic outlook elsewhere remains encouraging as globalisation expands market access and emerging markets grow stronger, forcing competitive restructuring. The financial markets are playing a major part in this realignment by financing the infrastructure needed to deliver the necessary energy and material resources from producer to consumer nations, and by facilitating trade flows. Additionally, financial markets are providing more sophisticated tools to help personal customers plan their long-term financial affairs,

corporates to hedge their business risks and investors to manage their portfolio risks. The demand for financial services, therefore, remains strong, particularly for internationally linked services. This plays to HSBC's huge competitive strengths.

The most significant risks to continuing growth currently relate to political and macro events which are outside our control. Recognising that the effect of such risks materialising could be immediate and potentially severe, we remain strongly capitalised and liquid.

The Board of HSBC Holdings plc will continue to oversee the pursuit of the company's goals by executive management and to exercise rigorous stewardship of your company.

Our focus as we enter 2007 is resolutely on continuing to play to our strengths of linking emerging and developed markets and building comparative advantage by utilising our scale and our local and international reach. We continue to see opportunities to deploy capital profitably to the long-term advantage of shareholders and are committed to so doing.

S K Green, *Group Chairman*
5 March 2007

[Back to Contents](#)

	<i>Page</i>
Principal activities	11
Strategic direction	11
Customer groups and global businesses	12
Personal Financial Services	13
Commercial Banking	16
Corporate, Investment Banking and Markets	18
Private Banking	20
Other	22
Analysis by customer group and global business	23
Geographical regions	26
Summary of geographical regions	26
Competitive environment	27
Europe	31
Hong Kong	48
Rest of Asia-Pacific	60
North America	75
Latin America	91
Other information	106
Products and services	106
Property	109
Legal proceedings	109

Principal activities

HSBC is one of the largest banking and financial services organisations in the world, with a market capitalisation of US\$212 billion at 31 December 2006.

Through its subsidiaries and associates, HSBC provides a comprehensive range of banking and related financial services. Headquartered in London, HSBC operates through long-established businesses and has an international network of over 10,000 properties in 82 countries and territories in five geographical regions: Europe; Hong Kong; Rest of Asia-Pacific, including the Middle East and Africa; North America and Latin America¹. Within these regions, a comprehensive range of financial services is offered to personal, commercial, corporate, institutional, investment and private banking clients. Services are delivered primarily by domestic banks, typically with large retail deposit bases, and consumer finance operations. Taken together, the five largest customers of HSBC do not account for more than one per cent of HSBC's income.

¹ In 2006, the geographical segment presentation was changed with the reclassification of Mexico and Panama from North America to South America, and the renaming of the latter as Latin America and the Caribbean ([Latin America]). Comparative data have been restated to bring them into line with the presentation adopted in 2006.

The principal acquisitions made during the year are described on page 369. There were no significant disposals.

Strategic direction

HSBC's strategic direction, as set out in its 'Managing for Growth' strategy, is to be the world's leading financial services company, with 'leading' meaning the HSBC brand is preferred to others and HSBC's corporate character is admired, its earnings per share growth is dynamic and it holds leadership positions in selected markets. Financial success is measured by comparing the Group's Total Shareholder Return ('TSR') target against a weighted TSR benchmark composed of a peer group of banks.

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To achieve its strategy, the Group has identified seven priorities or "global pillars" that will guide the Group's strategic initiatives in 2007 and 2008. Success in achieving the priorities will be assessed by reviewing a suite of key performance indicators, which are discussed on page 115. The global pillars are:

- to exploit HSBC's global reach by more effectively joining up the company by country, distribution channel, customer group and global business;
- to improve its customer experience so that customers feel that HSBC is the best place to bank;
- to invest in developing HSBC's brand and to encourage all staff to live HSBC's brand values in their day-to-day activities;
- to improve staff engagement by ensuring employment policies are progressive, perceptive, responsive, respectful and fair;
- to grow the business by focusing on deposit-taking and achieving the right balance between risk and reward;
- to enhance working practices and use technology more effectively to make it easier for customers to do business with the Group; and
- to clearly allocate responsibility for delivery of the above initiatives to country managers and heads of customer groups and global businesses, with Group Head Office and regional head offices providing guidance and, where appropriate, delegating authority.

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Business Review

(continued)

*Summary / Business highlights***Customer groups and global businesses**

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

Profit before tax

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

	Year ended 31 December					
	2006		2005		2004	
	US\$m	%	US\$m	%	US\$m	%
Personal Financial Services	9,457	42.8	9,904	47.2	8,497	44.9
Commercial Banking	5,997	27.2	4,961	23.7	4,057	21.4
Corporate, Investment Banking and Markets	5,806	26.3	5,163	24.6	5,288	27.9
Private Banking	1,214	5.5	912	4.4	697	3.7
Other	(388)	(1.8)	26	0.1	404	2.1
	22,086	100.0	20,966	100.0	18,943	100.0

Total assets

	At 31 December			
	2006		2005	
	US\$m	%	US\$m	%
Personal Financial Services	546,568	29.4	484,314	32.2
Commercial Banking	213,450	11.5	175,120	11.7
Corporate, Investment Banking and Markets	994,436	53.4	755,056	50.3
Private Banking	73,026	3.9	59,827	4.0
Other	33,278	1.8	27,653	1.8
	1,860,758	100.0	1,501,970	100.0

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

Profit before tax

	Year ended 31 December		
	2006 US\$m	2005 US\$m	2004 US\$m
Net interest income	26,076	23,351	21,422
Net fee income	8,762	7,313	6,406
Trading income excluding net interest income	391	360	320
Net interest income on trading activities	220	214	□
Net trading income ¹	611	574	320
Net income from financial instruments designated at fair value	739	574	□
Net investment income on assets backing policy-holders' liabilities	□	□	635
Gains less losses from financial investments	78	19	79
Dividend income	31	16	16
Net earned insurance premiums	5,130	4,864	3,652
Other operating income	782	729	360
Total operating income	42,209	37,440	32,890
Net insurance claims ²	(4,365)	(3,716)	(2,953)
Net operating income³	37,844	33,724	29,937
Loan impairment charges and other credit risk provisions	(9,949)	(7,537)	(6,500)
Net operating income	27,895	26,187	23,437
Total operating expenses	(18,818)	(16,427)	(15,009)
Operating profit	9,077	9,760	8,428
Share of profit in associates and joint ventures	380	144	69
Profit before tax	9,457	9,904	8,497
By geographical region			
Europe	1,909	1,932	1,621
Hong Kong	2,880	2,628	2,063
Rest of Asia-Pacific	477	377	336
North America ⁴	3,391	4,181	3,826
Latin America ⁴	800	786	651
Profit before tax	9,457	9,904	8,497
	%	%	%
Share of HSBC's profit before tax	42.8	47.2	44.9
Cost efficiency ratio	49.7	48.7	50.1

	US\$m	US\$m	US\$m
Selected balance sheet data⁵			
Loans and advances to customers (net)	448,545	398,884	370,576
Total assets	546,568	484,314	452,992
Customer accounts	388,468	321,240	319,485

For footnotes, see page 26.

Strategic direction

HSBC's strategic direction in Personal Financial Services is to be the world's preferred provider, with a top class ethical sales and service culture. Growth will be driven in key markets by offering attractive products through a range of appropriate delivery channels. The strategy focuses on:

- simplifying core products, delivered directly via the latest web-based technology and supported by newly designed modern customer-friendly branches in selected markets;
- facilitating direct multi-channel access to the Group's services, and building a high quality system to help manage banking relationships;
- enhancing HSBC *Premier* as a signature product for the Group, offering a premium banking service utilising HSBC's international capabilities; and
- concentrating growth in the consumer finance business in markets affording appropriate long-term risk-adjusted returns, and in new markets offering attractive potential for growth.

Business highlights in 2006

- Pre-tax profits from Personal Financial Services were US\$9,457 million in 2006, a decrease of 5 per cent on the previous year. This was caused by higher impairment charges, particularly in the US, which masked the increasing contributions from a number of key emerging markets, from HSBC's strategic investments in associates and from strong growth in Hong Kong. On an underlying basis, profit before tax was 8 per cent lower.
- Underlying growth in net operating income before loan impairment charges was 9 per cent. This was lower than cost growth, however, as HSBC invested approximately US\$400 million to extend distribution in emerging markets, add deposits through direct channels in the US and Taiwan, refurbish the branch network in the UK and generally improve direct channel capabilities. HSBC also added collection resources in the US in response to the rise in loan delinquency evident towards the end of the year.
- Loan impairment charges were 32 per cent higher, or 27 per cent on an underlying basis. This primarily reflected the effect of a slowing housing market and rising interest rates on sub-prime mortgage lending in the US, in particular where HSBC had a second lien position. The increase was concentrated in the correspondent

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Business Review

(continued)

Business highlights

channel, [mortgage services], which acquires loans from correspondent banks and mortgage brokers. Credit quality in the majority of other portfolios in the US was relatively stable. In Taiwan, a short-term increase in the first half of 2006 arose from government-sponsored measures to relieve over-indebtedness in the consumer sector, which had the effect of significantly increasing the number of customers successfully obtaining some element of debt restructuring. In Hong Kong, there was a return to a more normal level of charges following a net release in 2005; credit quality remained stable. In the UK, while overall charges as a percentage of lending were broadly stable, there was an increase in the consumer finance lending book, reflecting rising personal bankruptcies and Individual Voluntary Arrangements ([IVA]s), and the effect of increased consumer indebtedness on delinquency.

- Responding to a clear shift in customer preferences, HSBC continued to emphasise the development of direct channels within its distribution capabilities. Websites were updated to offer additional features, personalised content and improved customer accessibility. The new technology behind these developments gives HSBC enhanced targeting and analytical insights to better meet customer needs and drive sales growth. Overall, online personal customer numbers rose by nearly 40 per cent to 16 million and online sales volumes increased by more than 55 per cent compared with 2005.
- Following its successful launch in the US in 2005, HSBC's direct banking and savings proposition, HSBC Direct, was introduced in Taiwan – a first for HSBC in Asia. In the US, HSBC Direct customer numbers passed 343,000, with deposits exceeding US\$7.2 billion.
- To further its direct banking strategy, HSBC introduced 2,300 advanced self-service terminals offering a wider range of services than traditional ATMs (automated teller machines), including payments, enquiry and sales features. The functionality of over 11,000 traditional ATMs was also enhanced.
- The number of customers using HSBC *Premier* grew for the seventh consecutive year, to 1.8 million, an increase of 35 per cent compared with 2005. This service is now available in 36 countries.
- An innovation was the launch of seven-day opening in selected UK, US and Hong Kong branches. Investment in the retail network continued in Europe, North America and parts of Asia-Pacific.
- In the latter, HSBC began to introduce its Group-wide credit card system, expanded consumer finance in India and Indonesia, and agreed retail finance arrangements in mainland China and Australia.
- The efforts described above were recognised by *Retail Banker International* in naming HSBC the [Best Retail Bank] globally. HSBC was also named the [Best Global Bank - Best Consumer Bank] by *Global Finance* magazine. HSBC's online enhancements helped earn the [Best Global Consumer Internet Bank] award in the *Global Finance Awards*.

Europe

- In the UK, HSBC refined its approach to segmenting its customer base and aligned its products and distribution capabilities to better serve these segments. It refurbished 104 branches, increased the number of non-branch ATMs by over 35 per cent, including 135 in Marks & Spencer stores, and rolled out some 1,450 advanced self-service machines. This latter initiative was recognised by *The Banker* in awarding HSBC the

international [Technology Award for New Channels].

- In France, a focus on reinforcing HSBC's profile following the 2005 rebranding exercise drove a marked increase in brand awareness. HSBC was named [Best in Class] among French retail banks in a number of categories in the *Cosmosbay Vectis Survey*.
- HSBC opened new branches in the UK, Turkey, France and Malta. In Eastern Europe, HSBC developed its consumer finance operations with the establishment of a regional head office and management team.

Hong Kong

- Efforts to expand the scope of internet banking and increase the proportion of transactions conducted online proved successful. Fewer than 4.3 per cent of all transactions were conducted through the branch network in 2006, while the proportion of sales conducted online reached nearly one quarter. HSBC was named the [Best Consumer Internet Bank] in Hong Kong in the annual *Global Finance Awards*.
- Wealth management, including insurance, was a focal point in 2006, and enhancements to

[Back to Contents](#)

HSBC's product and channel offerings delivered a 50 per cent rise in sales of investment related funds.

- HSBC maintained its position as the largest credit card issuer in Hong Kong with over 4.6 million cards in force. HSBC was named "MasterCard Hong Kong Bank of the Year" for a record sixth consecutive time.

Rest of Asia-Pacific

- HSBC invested in selected markets within the region, notably in cards, consumer finance, insurance, direct banking and Islamic banking. New branches were opened in India, mainland China, Malaysia and Bangladesh.
- The Hongkong and Shanghai Banking Corporation Limited and Hang Seng Bank had 30 and 15 service outlets in mainland China respectively at 31 December 2006 and continued to maintain the largest network amongst foreign banks.
- Credit cards remained a key area of growth in the region. The number of cards in force rose by 1.2 million to 7.3 million.

North America

- HSBC's growth strategy is built around deposit gathering through selective branch expansion, competitive pricing, in part enabled by increasing internet delivery, and improved marketing and customer analytics. All these strands to the strategy were developed during 2006.
- Driven by the success of the online savings product and branch expansion, deposit balances in the US grew by 25 per cent in 2006. US\$9 billion of deposits have been attracted since the launch of the deposit gathering strategy there in 2005, of which US\$718 million have been generated from new branches since the expansion programme began in the same year.
- The integration of the credit card business of Metris Companies Inc. ("Metris"), acquired in 2005 for approximately US\$1.6 billion, was completed. The business performed above expectations, generating US\$233 million of profit before tax.
- HSBC Finance Corporation ("HSBC Finance") completed the acquisition of the Champion Mortgage portfolio during 2006, adding US\$2.5 billion in mostly first lien sub-prime mortgages.
- In the US, HSBC entered into an agreement which extended the brands under which it is able to offer cards, uniquely, to American Express, Discover Network, MasterCard and Visa. The retail services business launched co-branded initiatives with Saks, Neiman Marcus and Best Buy. HSBC is now the seventh largest card issuer in the US.
- Asset growth continued in Canada with strong consumer spending resulting in higher personal lending and mortgage balances. Led by the success of new products such as the High Rate Savings Account, deposit balances rose.

Latin America

- The Personal Financial Services business in Mexico continued to grow strongly in credit cards, mortgages, personal loans and the industry-leading "Tu Cuenta" packaged account which passed 1 million account holders in 2006. HSBC was the first bank to offer pre-approved online mortgages and received an award for the "Best

Integrated Consumer Bank Site in Latin America from *Global Finance* magazine.

- The credit card business across the region continued to expand strongly. In Mexico, the number of cards in circulation rose by 76 per cent to 1.7 million, average balances more than doubled, and market share improved by 230 basis points. In Brazil, record credit card sales were reported and, in Argentina, the number of cards in issue increased by 39 per cent.
- The acquisition of Banistmo, with 1.3 million existing customers, complements HSBC's existing operations in the region and establishes a presence in five new markets; Colombia, Costa Rica, El Salvador, Honduras and Nicaragua, providing access to a total population of 83 million people.
- In Argentina, HSBC acquired the operations of Banca Nazionale del Lavoro (BNL), whose 92 branches will establish a more substantial and geographically diverse presence in retail banking.
- In Brazil, the consumer finance division, Losango, saw strong growth in store loans. Vehicle finance, payroll and credit card lending all grew strongly too, augmented by new retail partnerships which increased market access.

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Business Review

(continued)

Business highlights**Commercial Banking**

Profit before tax

	Year ended 31 December		
	2006 US\$m	2005 US\$m	2004 US\$m
Net interest income	7,514	6,310	4,875
Net fee income	3,207	2,876	2,645
Trading income excluding net interest income	204	150	234
Net interest income/ (expense) on trading activities	20	(3)	□
Net trading income ¹	224	147	234
Net expense from financial instruments designated at fair value	(22)	(12)	□
Net investment income on assets backing policy-holders' liabilities	□	□	324
Gains less losses from financial investments	44	9	6
Dividend income	6	9	37
Net earned insurance premiums	258	236	1,072
Other operating income	250	327	513
Total operating income	11,481	9,902	9,706
Net insurance claims ²	(96)	(118)	(1,264)
Net operating income³	11,385	9,784	8,442
Loan impairment charges and other credit risk provisions	(697)	(547)	(200)
Net operating income	10,688	9,237	8,242
Total operating expenses	(4,979)	(4,453)	(4,220)
Operating profit	5,709	4,784	4,022
Share of profit in associates and joint ventures	288	177	35
Profit before tax	5,997	4,961	4,057
By geographical region			
Europe	2,234	1,939	1,663
Hong Kong	1,321	955	904
Rest of Asia-Pacific	1,034	818	483
North America ⁴	957	892	691
Latin America ⁴	451	357	316

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	5,997	4,961	4,057
	%	%	%
Profit before tax			
Share of HSBC's profit before tax	27.2	23.7	21.4
Cost efficiency ratio	43.7	45.5	50.0
	US\$m	US\$m	US\$m
Selected balance sheet data⁵			
Loans and advances to customers (net)	172,976	142,041	130,160
Total assets	213,450	175,120	159,251
Customer accounts	190,853	148,106	137,801

For footnotes, see page 26

Strategic direction

HSBC's strategy is to be the leading international business bank for Commercial Banking customers, with a particular focus on being the best bank for small businesses in target markets, by:

- making full use of HSBC's extensive geographical network to support Commercial Banking customers in trading, investing and commencing business across borders;
- building upon HSBC's Global Transaction Banking and receivables finance expertise to facilitate domestic and international trade flows;
- deepening HSBC's understanding of its customers through research and segmentation and tailoring services to meet their needs;
- developing multi-channel relationships and further enhancing and rolling out direct Commercial Banking services; and
- enhancing service levels and driving efficiencies by making full use of HSBC's operational processing and IT capabilities.

Business highlights in 2006

- Pre-tax profit increased by 21 per cent to US\$5,997 million, driven by strongly rising operating income. This comfortably exceeded the increased loan impairment charges and higher costs associated with business expansion. The cost efficiency ratio improved from 45.5 per cent to 43.7 per cent. On an underlying basis, profits increased by 19 per cent. Since 2004, Commercial Banking's pre-tax profits have grown by approximately 48 per cent.
- Customer loans and accounts grew by 22 per cent and 29 per cent respectively and customer numbers increased by 116,000 to 2.6 million. Global Transaction Banking revenue from Commercial Banking customers increased by 14 per cent to US\$3.9 billion.
- As part of its strategy to be recognised as the leading international business bank, HSBC continued to invest in initiatives designed to facilitate customers' cross-border activities. International Business Centres were established in 16 locations and a new cross-border credit arrangement was launched, in order to recognise HSBC's global relationship with international customers in making local lending decisions. These milestones, together with the implementation of a new referral system, led to international referrals with an aggregate facility

[Back to Contents](#)

value of US\$3 billion, involving over 50 sites and 4,000 relationship managers.

- HSBC achieved considerable success in pursuit of its objective to be the best bank for small business. Customer numbers increased in response to the launch of specialised Commercial Banking centres and new products tailored to meet their needs.
- Development of HSBC's IT platform for business banking contributed to a 29 per cent increase in customers registered for internet banking. Online transaction volumes increased by 22 per cent and web traffic grew by 41 per cent to over 132 million user sessions.
- HSBC continued to develop its commercial insurance and wealth management capabilities, hiring new staff, establishing specialist teams and offering new products.

Europe

- As part of its emerging market focus, HSBC expanded its Eastern European operations by adding new premises, developing Global Transaction Banking capabilities and strengthening local relationship management teams.
- BusinessDirect, which provides small and micro businesses with a no-fee internet and phone banking service, was successfully launched in the UK.
- HSBC opened 11 innovative Commercial Centres in the UK, providing state-of-the-art business facilities in more convenient locations for business customers.
- In Turkey, HSBC reinforced product launches and other initiatives undertaken in 2005 by establishing a small and micro business presence in 55 Commercial Centres. This contributed to a 40 per cent rise in active Commercial Banking customer numbers.
- In France, HSBC raised its brand profile in the business community, which led to new customer numbers increasing by approximately a third.

Hong Kong

- HSBC was named "World's Best Trade Finance Bank in Hong Kong" by *Global Finance* magazine, recognising the bank's efforts in developing a centre of excellence for international trade.
- A new micro-business lending programme was launched, with a streamlined loan application process for new and existing customers which, in conjunction with campaigns to increase usage, led to a doubling of lending to micro businesses.
- Three Commercial Transaction Centres were opened to provide tailored Commercial Banking services in lower cost sites near to customers.

Rest of Asia-Pacific

- As Asian trade flows expanded strongly, HSBC opened International Banking Centres in seven sites in the Rest of Asia-Pacific during 2006. HSBC's strength in international trade was recognised with a number of Trade Finance awards including *Global Finance* magazine's "World's Best Trade Finance Bank in Asia".
- Branches focused on Commercial Banking were opened in mainland China, India and Bangladesh. A commercial customer call centre was opened in South Korea, while Shariah-compliant Amanah services for commercial customers were rolled out in the Middle East.

- Small businesses benefited from a number of new products and services including an online business insurance package in the Middle East and a new receivables finance product in India.

North America

- HSBC continued to expand its operations outside New York State. New branches were opened in Chicago, Los Angeles, New Jersey, Connecticut and Washington D.C., supported by a 13 per cent increase in the number of relationship managers.
- The launch of International Banking Centres in the US and Canada resulted in an increased focus on international business opportunities.

Latin America

- HSBC opened International Banking Centres in Mexico and Brazil and commenced Commercial Banking operations in Peru. In Argentina, HSBC opened a dedicated trade services call centre.
- HSBC's share of the international trade market in Mexico grew following service enhancements and the launch of new products, including "Estimulo Empresarial", a packaged product targeted at small businesses.
- In Brazil, enhancements to the *giro fácil* revolving loan and overdraft facility for small businesses led to record sales.

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Business Review

(continued)

*Business highlights***Corporate, Investment Banking and Markets**

Profit before tax

	Year ended 31 December		
	2006 US\$m	2005 US\$m	2004 US\$m
Net interest income	3,168	3,001	3,994
Net fee income	3,718	2,967	2,764
Trading income excluding net interest income	4,890	2,919	1,935
Net interest income/ (expense) on trading activities	(379)	306	□
Net trading income ¹	4,511	3,225	1,935
Net income from financial instruments designated at fair value	20	67	□
Net investment income on assets backing policy- holders' liabilities	□	□	9
Gains less losses from financial investments	534	475	197
Dividend income	235	79	548
Net earned insurance premiums	73	76	86
Other operating income	1,378	1,621	1,029
Total operating income	13,637	11,511	10,562
Net insurance claims ²	(62)	(54)	(59)
Net operating income³	13,575	11,457	10,503
Net recovery of loan impairment charges and other credit risk provisions	119	272	499
Net operating income	13,694	11,729	11,002

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Total operating expenses	(7,991)	(6,838)	(5,809)
Operating profit	5,703	4,891	5,193
Share of profit in associates and joint ventures	103	272	95
Profit before tax	5,806	5,163	5,288
By geographical region			
Europe	2,304	2,114	1,668
Hong Kong	955	922	1,603
Rest of Asia-Pacific	1,649	1,207	942
North America ⁴	423	573	879
Latin America ⁴	475	347	196
Profit before tax	5,806	5,163	5,288

	%	%	%
Share of HSBC's profit before tax	26.3	24.6	27.9
Cost efficiency ratio	58.9	59.7	55.3

For footnotes, see page 26

Strategic direction

HSBC's strategy is to be a leading wholesale bank by focusing on financing and emerging markets, and:

- leveraging the Group's unique footprint and heritage;
- using HSBC's network and client franchises as the foundation on which Corporate, Investment Banking and Markets develops its hub-and-spoke business model; and
- continuing to build skills and capabilities in its major centres to support the delivery of an advanced suite of services to corporate, institutional and government clients across the HSBC network.

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

Business highlights in 2006

- Pre-tax profit rose by 12 per cent to US\$5,806 million, driven by an 18 per cent increase in total operating income. This was achieved despite a declining contribution from balance sheet management activities, which fell by US\$534 million as existing positions unwound and opportunities for reinvestment were limited by the flat interest rate yield curve environment. On an underlying basis and excluding balance sheet management activities, total operating income improved by 24 per cent, reflecting positive revenue trends in product areas in which HSBC has invested. The increase in operating expenses reflected the first full-year effect of recruitment in 2005. Performance-related compensation increased in line with robust revenue growth, while higher operational costs reflected volume increases in payments and cash management and securities services. The cost efficiency ratio improved moderately. In 2006, over 1,700 people were recruited and 1,150 departed.

- Corporate, Investment Banking and Markets strength in emerging markets was recognised by industry awards. HSBC was named European Loan House of the Year, China Loan House of the Year and Asian Domestic Currency Bond House of the Year by *International Financing Review*. Mittal Steel's acquisition of Arcelor, in which HSBC held senior financing and advisory roles, was voted European mergers and acquisitions Deal of the Year by *Financial News* and Cross-Border Deal of the Year by

[Back to Contents](#)**Management view of total operating income**

	Year ended 31 December		
	2006	2005	2004
	US\$m	US\$m	US\$m
Global Markets	5,279	3,767	3,171
Foreign exchange	1,516	1,200	1,125
Credit and Rates	1,321	931	655
Structured derivatives	725	387	386
Equities	381	324	256
HSBC Securities			
Services	1,336	925	749
Global Banking	4,059	3,530	3,065
Investment banking	1,156	1,022	877
Lending	1,257	1,260	1,188
Payments and cash management	1,249	901	694
Other transaction services	397	347	306
Balance sheet management	704	1,238	2,376
Group Investment Businesses	1,104	762	732
Private equity	564	648	207
Other ¹	1,927	1,566	1,011
Total operating income	13,637	11,511	10,562

Selected balance sheet data⁵

Loans and advances to:

□ customers (net)	210,220	169,435	145,353
□ banks (net)	156,548	106,123	128,032
Total assets	994,436	755,056	584,779
Customer accounts	235,965	202,361	177,449
Trading assets, financial instruments designated at fair value, and financial investments	487,943	373,787	252,459
Deposits by banks	92,954	65,853	80,443

¹ □Other□ includes the Corporate, Investment Banking and Markets business of HSBC Trinkaus & Burkhardt AG, the effect of consolidating investments held by HSBC□s property investment funds, and net interest earned on free capital held in Corporate, Investment Banking and Markets not assigned to products.

For other footnotes, see page 26.

Acquisitions Monthly. HSBC was named Best Investment Bank in the Middle East and, for the ninth consecutive year, Best at Treasury and Risk Management in Asia by *Euromoney*, and Best Foreign Bank in China, Indonesia, Malaysia and Vietnam by *FinanceAsia*.

- In Global Markets, operating income increased by 40 per cent, with robust growth in foreign exchange, Credit and Rates and structured derivatives complemented by a significant increase in securities services revenues. Foreign exchange gains were driven by increased customer activity, encouraged by US dollar weakness and volatility in emerging markets. Credit and Rates revenue was boosted by an enhanced product range, market volatility and increased investor appetite for emerging market bonds. A substantial rise in structured derivatives income reflected enhanced sales coverage. The securities services business benefited from increased customer volumes in higher-value products and strong income growth in emerging markets. Assets under custody rose by 28 per cent.
- In Global Banking, total operating income rose by 15 per cent, due to a strong performance in payments and cash management and improved results in investment banking. In the latter, satisfactory progress in capital markets resulted in HSBC being ranked fourth in the international bond league table, according to Bloomberg, up from fifth in 2005 and seventh in 2004, and first in the Asian local currency bond league table for the fifth consecutive year.

Cross-border distribution was a noteworthy feature of many HSBC-led debt capital market and equity capital market transactions. Highlights included America Movil's 8 billion Mexican peso bond; Khazanah Nasional of Malaysia's US\$750 million exchangeable Sukuk; and Shui On Land's US\$876 million Initial Public Offering (IPO) in Hong Kong.

Income from the lending business was broadly in line with 2005. Globally, the corporate credit environment was stable, though corporate spreads remained under pressure. HSBC made significant progress in leveraged and acquisition finance in 2006. Key transactions included debt facilities backing Yell Group's acquisition of Telefonica Publicidad e Informacion and a Macquarie Bank-led consortium's acquisition of Thames Water.

Payments and cash management delivered a strong performance across all regions, driven by growth in client deposits and improved spreads.

- Group Investment Businesses' operating income rose by 45 per cent partly due to higher performance fees on emerging market funds and strong results from quantitative and multi-manager products. Funds under management grew by 11 per cent, driven by supportive market conditions and US\$14 billion of net client inflows, including significant inflows into emerging market funds.

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Business Review

(continued)

Business highlights**Private Banking**

Profit before tax

	Year ended 31 December		
	2006 US\$m	2005 US\$m	2004 US\$m
Net interest income	1,011	848	718
Net fee income	1,323	1,080	962
Net trading income ¹	364	317	257
Net income/(expense) from financial instruments designated at fair value	1	(1)	□
Gains less losses from financial investments	166	45	39
Dividend income	5	9	5
Other operating income	61	68	24
Total operating income	2,931	2,366	2,005
Net insurance claims ²	□	□	□
Net operating income³	2,931	2,366	2,005
Loan impairment (charges)/recoveries and other credit risk provisions	(33)	12	11
Net operating income	2,898	2,378	2,016
Total operating expenses	(1,685)	(1,466)	(1,319)
Operating profit	1,213	912	697
Share of profit in associates and joint ventures	1	□	□
Profit before tax	1,214	912	697
By geographical region			
Europe	805	539	438
Hong Kong	201	190	131
Rest of Asia-Pacific	80	78	60
North America ⁴	114	104	68
Latin America ⁴	14	1	□
Profit before tax	1,214	912	697
	%	%	%
Share of HSBC's profit before tax	5.5	4.4	3.7
Cost efficiency ratio	57.5	62.0	65.8

	US\$m	US\$m	US\$m
Selected balance sheet data⁵			
Loans and advances to customers (net)	34,297	27,749	24,463
Total assets	73,026	59,827	56,751
Customer accounts	80,303	67,205	57,780

For footnotes, see page 26

Strategic direction

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

HSBC's global network and brand provides a base from which the private bank, working in conjunction with HSBC's other customer groups and global businesses, serves the complex international needs of its clients, utilising traditional and innovative ways of managing and preserving the wealth of high net worth individuals while optimising returns.

The private bank's strategy is to reinforce its product capabilities in areas such as credit, hedge funds, investment advice and estate planning. This will be achieved by attracting, retaining and motivating talented individuals, by surveying clients and employees on a regular basis and by increasing expenditure targeted on marketing and brand awareness initiatives. Private Banking's onshore business will also be expanded.

Business highlights

- Pre-tax profits of US\$1,214 million grew by 33 per cent on both reported and underlying bases compared with 2005, supported by strong growth in client assets and lending. Revenue growth comfortably exceeded cost growth leading to an improvement in the cost efficiency ratio of 4.5 percentage points to 57.5 per cent. Reported pre-tax profits have increased by 74 per cent since 2004.
- A significant gain of US\$117 million arose from the partial sale of an investment in the Hermitage fund, a public equity fund dedicated to investment in Russia.
- HSBC continued to expand its alternative investment platform as client preferences favoured such investments. Total client investment in hedge funds reached US\$39 billion. Two funds managed by HSBC Private Bank France received first and equal second place in the L'Agefi awards [International Equity Category].
- Client assets increased by 22 per cent to US\$333 billion, with net new money inflows of US\$34 billion in 2006. On an underlying basis, growth was 17 per cent.

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

	2006	2005
	US\$bn	US\$bn
At 1 January	273	239
Net new money	34	36
Value change	21	13
Exchange and other	5	(15)
	<hr/>	<hr/>
Total	333	273
	<hr/>	<hr/>

Client assets by investment class

	2006	2005
	US\$bn	US\$bn
Equities	62	51
Bonds	55	53
Structured products	16	9
Funds	83	67
Cash, fiduciary deposits and other	117	93
	<hr/>	<hr/>
Total	333	273
	<hr/>	<hr/>

- Strong performance of the Strategic Investment Solutions (SIS) and related Core Investment Solutions (CIS) products was reflected in greater investment by clients in this suite of discretionary managed products, which reached a value of US\$4.8 billion.
- Recognising the value to be derived from closer links with other customer groups, dedicated teams working with Commercial Banking, Personal Financial Services and Corporate, Investment Banking and Markets produced a significant increase in intra-Group referrals in 2006.
- The lending book grew strongly to satisfy demand from clients for finance to invest in residential properties and other asset classes.
- HSBC won a number of awards in the *Euromoney* annual private banking survey. In the global private banking awards, notable wins included 1st Private Bank for Services for the Super Affluent and 1st Private Bank for Islamic Services. HSBC maintained its position in the top three within the Best private banking services overall category.

Europe

- In Europe, HSBC's Private Banking operations had a very strong year on the back of recruitment of client-facing staff and marketing in key growth regions.
- Synergies were achieved in Switzerland, through the merger of the two existing Swiss trust businesses and the two Lugano branches.

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- Private Banking expanded its onshore business through the launch of further regional offices in Bristol and Manchester in the UK and in Bordeaux, Marseille and Nice in France.
- Client assets increased by 25 per cent, or 18 per cent on an underlying basis, with net new money reaching US\$19 billion, primarily driven by the Swiss business.

Asia

- Front office recruitment continued in Hong Kong and Singapore and Private Banking capabilities were expanded through the opening of representative offices in mainland China and the Philippines.
- Investment in Taiwan, Japan and the Middle East continued and, in India, the private bank network expanded to six offices with the addition of Chennai and Hyderabad.
- Client assets increased by 26 per cent, or 23 per cent on an underlying basis with net new money reaching US\$9 billion.

Americas

- HSBC expanded its presence in the US with the opening of domestic Private Banking offices in Chicago and Greenwich.
- Wealth and Tax Advisory Services (WTAS) generated strong growth in revenue and expanded through the opening of offices in Palo Alto, Seattle, Fort Washington, Greenwich and Chicago.
- Client assets increased by 6 per cent with net new money reaching US\$6 billion.

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Business Review

(continued)

Business highlights**Other**

Profit before tax

	Year ended 31 December		
	2006 US\$m	2005 US\$m	2004 US\$m
Net interest income/(expense)	(625)	(472)	90
Net fee income	172	220	171
Trading income/(expense) excluding net interest income	(228)	(90)	40
Net interest income/(expense) on trading activities	82	(13)	□
Net trading income/(expense) ¹	(146)	(103)	40
Net income/(expense) from financial instruments designated at fair value	(81)	406	□
Net investment income on assets backing policy-holders' liabilities	□	□	44
Gains less losses from financial investments	147	144	219
Dividend income	63	42	16
Net earned insurance premiums	207	260	558
Other operating income	3,254	2,634	2,050
Total operating income	2,991	3,131	3,188
Net insurance claims ²	(181)	(179)	(359)
Net operating income³	2,810	2,952	2,829
Loan impairment charges and other credit risk provisions	(13)	(1)	(1)
Net operating income	2,797	2,951	2,828
Total operating expenses	(3,259)	(2,976)	(2,493)
Operating profit/(loss)	(462)	(25)	335
Share of profit in joint ventures and associates	74	51	69
Profit/(loss) before tax	(388)	26	404
By geographical region			
Europe	(278)	(168)	366
Hong Kong	(175)	(178)	129
Rest of Asia-Pacific	287	94	26
North America ⁴	(217)	165	(196)

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Latin America ⁴	(5)	113	79
Profit/(loss) before tax	(388)	26	404
	%	%	%
Share of HSBC's profit before tax	(1.8)	0.1	2.1
Cost efficiency ratio	116.0	100.8	88.1
	US\$m	US\$m	US\$m

Selected balance sheet data⁵

Loans and advances to customers (net)	2,095	1,893	2,339
Total assets	33,278	27,653	26,201
Customer accounts	1,245	507	557

Notes

- For a description of the main items reported under "Other", see footnote 6 on page 26.
- HSBC sold a number of properties in Hong Kong and the Rest of Asia-Pacific region, realising gains of US\$187 million, significantly higher than in 2005. These sales led to a reduction in the size of HSBC's property portfolio which, together with slower growth in Hong Kong property prices, resulted in a 59 per cent decrease in property revaluation gains to US\$61 million.
- The sale of part of HSBC's stake in UTI Bank Limited realised a gain of US\$101 million in the first half of 2006.
- HSBC reported a US\$95 million fall in the fair value of own debt designated at fair value in 2006, compared with a gain of US\$386 million in 2005. The movement was principally in North America and Europe.
- Higher US interest rates led to increased costs to HSBC of servicing its floating rate subordinated debt, partly offset by higher earnings on US dollar-denominated centrally held funds.
- The development of HSBC's ten Group Service Centres, primarily in India and mainland China, continued apace and staff numbers increased by 32 per cent to 25,000. Increased activity in the centres resulted in a 54 per cent increase in costs to US\$343 million. The recovery of substantially all of these costs from the relevant customer groups is reported under "Other operating income".
- Increased business volumes, branch expansion, the development of new IT capabilities and the integration of Metris led to an 8 per cent increase in costs at the Group's North American technology centre to US\$1,191 million, also recharged through "Other operating income".
- During 2005, HSBC in Argentina benefited from certain gains associated with the receipt of coverage bonds and other items related to the 2002 sovereign debt crisis. These benefits were not repeated in 2006.

For footnotes, see page 26.

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

Profit/(loss) before tax

Year ended 31 December 2006

Total	Personal Financial Services US\$m	Commercial Banking US\$m	Corporate, Investment Banking & Markets US\$m	Private Banking US\$m	Other⁶ US\$m	Inter- segment elimination US\$m	Total US\$m
Net interest income/(expense)	26,076	7,514	3,168	1,011	(625)	(2,658)	34,486
Net fee income	8,762	3,207	3,718	1,323	172	□	17,182
Trading income/(expense) excluding net interest income	391	204	4,890	362	(228)	□	5,619
Net interest income/ (expense) on trading activities	220	20	(379)	2	82	2,658	2,603
Net trading income/(expense) ¹	611	224	4,511	364	(146)	2,658	8,222
Net income/(expense) from financial instruments designated at fair value	739	(22)	20	1	(81)	□	657
Gains less losses from financial investments	78	44	534	166	147	□	969
Dividend income	31	6	235	5	63	□	340
Net earned insurance premiums	5,130	258	73	□	207	□	5,668
Other operating income	782	250	1,378	61	3,254	(3,179)	2,546
Total operating income	42,209	11,481	13,637	2,931	2,991	(3,179)	70,070
Net insurance claims ²	(4,365)	(96)	(62)	□	(181)	□	(4,704)
Net operating income³	37,844	11,385	13,575	2,931	2,810	(3,179)	65,366

Loan impairment (charges)/recoveries and other credit risk provisions	<u>(9,949)</u>	<u>(697)</u>	<u>119</u>	<u>(33)</u>	<u>(13)</u>	<u>□</u>	<u>(10,573)</u>
Net operating income	27,895	10,688	13,694	2,898	2,797	(3,179)	54,793
Total operating expenses	<u>(18,818)</u>	<u>(4,979)</u>	<u>(7,991)</u>	<u>(1,685)</u>	<u>(3,259)</u>	<u>3,179</u>	<u>(33,553)</u>
Operating profit/(loss)	9,077	5,709	5,703	1,213	(462)	□	21,240
Share of profit in associates and joint ventures	<u>380</u>	<u>288</u>	<u>103</u>	<u>1</u>	<u>74</u>	<u>□</u>	<u>846</u>
Profit/(loss) before tax	9,457	5,997	5,806	1,214	(388)	□	22,086
	%	%	%	%	%		%
Share of HSBC's profit before tax	42.8	27.2	26.3	5.5	(1.8)		100.0
Cost efficiency ratio	49.7	43.7	58.9	57.5	116.0		51.3
	US\$m	US\$m	US\$m	US\$m	US\$m		US\$m
Selected balance sheet data⁵							
Loans and advances to customers (net)	448,545	172,976	210,220	34,297	2,095		868,133
Total assets	546,568	213,450	994,436	73,026	33,278		1,860,758
Customer accounts	388,468	190,853	235,965	80,303	1,245		896,834
The following assets and liabilities were significant to Corporate, Investment Banking and Markets:							
loans and advances to banks (net)			156,548				

trading assets, financial assets designated at fair value, and financial investments	487,943
deposits by banks	92,954

*For footnotes,
see page 26.*

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Business Review

(continued)

Customer groups and global businesses / Profit/(loss) before tax

Profit/(loss) before tax (continued)

Year ended 31 December 2005

Total	Year ended 31 December 2005						Total US\$m
	Personal Financial Services US\$m	Commercial Banking US\$m	Corporate, Investment Banking & Markets US\$m	Private Banking US\$m	Other ⁶ US\$m	Inter- segment elimination US\$m	
Net interest income/(expense)	23,351	6,310	3,001	848	(472)	(1,704)	31,334
Net fee income	7,313	2,876	2,967	1,080	220	□	14,456
Trading income/(expense) excluding net interest income	360	150	2,919	317	(90)	□	3,656
Net interest income/ (expense) on trading activities	214	(3)	306	□	(13)	1,704	2,208
Net trading income/(expense) ¹	574	147	3,225	317	(103)	1,704	5,864
Net income/(expense) from financial instruments designated at fair value	574	(12)	67	(1)	406	□	1,034
Gains less losses from financial investments	19	9	475	45	144	□	692
Dividend income	16	9	79	9	42	□	155
Net earned insurance premiums	4,864	236	76	□	260	□	5,436
Other operating income	729	327	1,621	68	2,634	(2,646)	2,733
Total operating income	37,440	9,902	11,511	2,366	3,131	(2,646)	61,704
Net insurance claims ²	(3,716)	(118)	(54)	□	(179)	□	(4,067)
Net operating income³	33,724	9,784	11,457	2,366	2,952	(2,646)	57,637
Loan impairment (charges)/recoveries and other credit risk provisions	(7,537)	(547)	272	12	(1)	□	(7,801)

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Net operating income	26,187	9,237	11,729	2,378	2,951	(2,646)	49,836
Total operating expenses	(16,427)	(4,453)	(6,838)	(1,466)	(2,976)	2,646	(29,514)
Operating profit/(loss)	9,760	4,784	4,891	912	(25)	□	20,322
Share of profit in associates and joint ventures	144	177	272	□	51	□	644
Profit before tax	9,904	4,961	5,163	912	26	□	20,966
	%	%	%	%	%		%

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

Selected balance sheet data⁵

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

The following assets and liabilities were significant

to Corporate, Investment Banking and Markets:

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

For footnotes, see page 26.

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[Back to Contents](#)

Year ended 31 December 2004

	Personal Financial Services US\$m	Commercial Banking US\$m	Corporate, Investment Banking & Markets US\$m	Private Banking US\$m	Other ⁶ US\$m	Inter- segment elimination US\$m	Total US\$m
Total							
Net interest income	21,422	4,875	3,994	718	90	□	31,099
Net fee income	6,406	2,645	2,764	962	171	□	12,948
Trading income	320	234	1,935	257	40	□	2,786
Net investment income on assets backing policy holders'□ liabilities	635	324	9	□	44	□	1,012
Gains less losses from financial investments	79	6	197	39	219	□	540
Dividend income	16	37	548	5	16	□	622
Net earned insurance premiums	3,652	1,072	86	□	558	□	5,368
Other operating income	360	513	1,029	24	2,050	(2,363)	1,613
Total operating income	32,890	9,706	10,562	2,005	3,188	(2,363)	55,988
Net insurance claims ²	(2,953)	(1,264)	(59)	□	(359)	□	(4,635)
Net operating income³	29,937	8,442	10,503	2,005	2,829	(2,363)	51,353
Loan impairment (charges)/ recoveries and other credit risk provisions	(6,500)	(200)	499	11	(1)	□	(6,191)
Net operating income	23,437	8,242	11,002	2,016	2,828	(2,363)	45,162
Total operating expenses	(15,009)	(4,220)	(5,809)	(1,319)	(2,493)	2,363	(26,487)
Operating profit	8,428	4,022	5,193	697	335	□	18,675
Share of profit in associates and joint ventures	69	35	95	□	69	□	268
Profit before tax	8,497	4,057	5,288	697	404	□	18,943
	%	%	%	%	%		%
Share of HSBC's□ profit before tax	44.9	21.4	27.9	3.7	2.1		100.0
Cost efficiency ratio	50.1	50.0	55.3	65.8	88.1		51.6

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	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m
Selected balance sheet data ⁵						
Loans and advances to customers (net)	370,576	130,160	145,353	24,463	2,339	672,891
Total assets	452,992	159,251	584,779	56,751	26,201	1,279,974
Customer accounts	319,485	137,801	177,449	57,780	557	693,072
The following assets and liabilities were significant to Corporate, Investment Banking and Markets:						
□loans and advances to banks (net)			128,032			
□trading assets, financial assets designated at fair value, and financial investments			252,459			
□deposits by banks			80,443			

For footnotes, see page 26.

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Business Review

(continued)

*Geographical regions > Summary / Competitive environment***Basis of preparation**

The results are presented in accordance with the accounting policies used in the preparation of HSBC's consolidated financial statements. HSBC's operations are closely integrated and, accordingly, the presentation of customer group data includes internal allocations of certain items of income and expense. These allocations include the costs of certain support services and head office functions, to the extent that these can be meaningfully attributed to operational business lines. While such allocations have been made on a systematic and consistent basis, they necessarily involve a degree of subjectivity.

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

Footnotes to the analyses of customer groups and global businesses on pages 12 to 25.

- 1 *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.*
- 2 *Net insurance claims incurred and movement in policyholders' liabilities.*
- 3 *Net operating income before loan impairment charges and other credit risk provisions.*
- 4 *In 2006, Mexico and Panama were reclassified from the North America segment to Latin America. Comparative information has been restated accordingly.*
- 5 *Third party only.*
- 6 *The main items reported under "Other" are the income and expenses of wholesale insurance operations, certain property activities, unallocated investment activities including hsbc.com, centrally held investment companies, movements in the fair value of own debt designated at fair value, and HSBC's holding company and financing operations. The results include net interest earned on free capital held centrally and operating costs incurred by the head office operations in providing stewardship and central management services to HSBC. Net operating income of the Group's wholesale insurance operations amounted to US\$371 million in 2006 (2005: US\$460 million; 2004: US\$511 million). "Other" also includes the costs incurred by the Group Service Centres and Shared Service Organisations and associated recoveries.*

Geographical regions**Summary of geographical regions**

In the analysis of profit by geographical regions that follows, operating income and operating expenses include intra-HSBC items of US\$1,494 million (2005: US\$938 million; 2004: US\$631 million).

Profit before tax

Year ended 31 December					
2006		2005		2004	
US\$m	%	US\$m	%	US\$m	%

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Europe	6,974	31.5	6,356	30.3	5,756	30.4
Hong Kong	5,182	23.5	4,517	21.5	4,830	25.5
Rest of Asia-Pacific	3,527	16.0	2,574	12.3	1,847	9.8
North America ¹	4,668	21.1	5,915	28.2	5,268	27.8
Latin America ¹	1,735	7.9	1,604	7.7	1,242	6.5
	22,086	100.0	20,966	100.0	18,943	100.0

Total assets²

At 31 December

	2006		2005	
	US\$m	%	US\$m	%
Europe	828,701	44.6	636,703	42.4
Hong Kong	272,428	14.6	235,376	15.7
Rest of Asia-Pacific	167,668	9.0	142,014	9.4
North America ¹	511,190	27.5	432,490	28.8
Latin America ¹	80,771	4.3	55,387	3.7
	1,860,758	100.0	1,501,970	100.0

¹ In 2006, Mexico and Panama were reclassified from the North America segment to the Latin America segment. Comparative information has been restated accordingly.

² Third party only.

[Back to Contents](#)

Additional information on results in 2006 may be found in the "Report of the Directors: Financial Review" on pages 110 to 164.

Europe

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

Hong Kong

HSBC's principal banking subsidiaries in Hong Kong are The Hongkong and Shanghai Banking Corporation Limited ("The Hongkong and Shanghai Banking Corporation") and Hang Seng Bank Limited ("Hang Seng Bank"). The former is the largest bank incorporated in Hong Kong and is HSBC's flagship bank in the Asia-Pacific region. It is one of Hong Kong's three note-issuing banks, accounting for more than 65 per cent by value of banknotes in circulation in 2006.

Rest of Asia-Pacific (including the Middle East)

The Hongkong and Shanghai Banking Corporation offers personal, commercial, corporate and investment banking and markets services in mainland China. The bank's network spans 12 major cities, comprising 14 branches and 16 sub-branches. Hang Seng Bank offers personal and commercial banking services and operates seven branches, seven sub-branches and one representative office in eight cities in mainland China. HSBC also participates indirectly in mainland China through its three associates, Bank of Communications Limited ("Bank of Communications") (19.9 per cent owned), Ping An Insurance (Group) Company of China, Limited ("Ping An Insurance") (16.8 per cent) and Industrial Bank Co. Ltd ("Industrial Bank") (12.78 per cent), and has a further interest of 8 per cent in Bank of Shanghai.

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

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

North America

HSBC's North American businesses are located in the US, Canada and Bermuda. Operations in the US are primarily conducted through HSBC Bank USA, N.A. ("HSBC Bank USA") which is concentrated in New York State, and HSBC Finance, a national consumer finance company based in Chicago. HSBC Bank Canada and The Bank of Bermuda Limited ("Bank of Bermuda") are responsible for operations in their respective countries.

Latin America

HSBC's operations in Latin America and the Caribbean principally comprise HSBC México, S.A. ("HSBC Mexico"), HSBC Bank Brasil S.A.-Banco Múltiplo ("HSBC Bank Brazil"), HSBC Bank Argentina S.A. ("HSBC Bank Argentina") and Grupo Banistmo S.A. ("Banistmo"). HSBC is also represented by subsidiaries in Chile, the Bahamas, Peru and Uruguay and, with the acquisition of Banistmo, in Costa Rica, Honduras, Colombia, Nicaragua and El Salvador, and by a representative office in Venezuela. In addition to banking services, HSBC operates large insurance businesses in Argentina, Brazil and Panama. In Argentina, HSBC's main insurance business is HSBC La Buenos Aires and, through Máxima and HSBC New York Life, HSBC offers pension and life insurance products. In Brazil, HSBC offers consumer finance products through its subsidiary, Losango.

Competitive environment

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

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Business Review

(continued)

Geographical regions > Competitive environment

and the investment banking operations of other commercial banks.

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

Global factors

Consolidation in the banking industry

Over the past few decades there has been a trend towards consolidation in banking and financial services, both nationally and internationally. This development has created a large and growing number of institutions which are capable of competing with HSBC across a wide range of services.

Limited market growth

The majority of HSBC's business is conducted in the domestic markets of the US, the UK and Hong Kong. In the UK and the US, penetration of standard banking services is nearing saturation, and potential for growth is largely in the provision of a wider range of financial services, including consumer finance, to new and existing customers. HSBC has increased its focus on its interconnected Hong Kong and mainland China businesses, the other emerging economies in Asia-Pacific, Latin America, the Middle East, Turkey and, to a lesser extent, Eastern Europe as the engines of future growth. This is being developed by expanding domestic operations within emerging markets and by concentrating capabilities in developed markets on servicing growing financial needs in the emerging markets.

Advances in technology

Over the past decade, the development of the internet and related innovative technologies has provided the financial services industry with the ability to deliver products and services through a growing number of channels, often more efficiently than by means of traditional face-to-face transactions. This has lowered barriers to entry and, as a consequence, competition has been fierce. Complementing its traditional branch network, HSBC offers a growing range of services utilising the new technologies, currently including the internet, interactive TV, mobile phone and WAP, and telephone banking. HSBC will continue to innovate

in these areas, and to offer its services through the channels preferred by its customers.

Regional factors

Europe

The European Commission commenced an inquiry into retail banking across all member states in 2006, with which HSBC's individual local entities cooperated fully. Published in January 2007, a final report highlighted concerns over the ways in which competition in banking was operating in Europe. No single country received particular attention.

The Single European Payments Area programme, which will integrate retail payments through harmonising euro currency transfers, bankers' orders and cards transactions in the eurozone, reached implementation phase. Full implementation is scheduled for 2008, according to an agreement signed by the 65 member banks of the European Payments Council. This should offer strong growth opportunities for some banks but is also expected to lead to more competition. HSBC is positioning itself to capitalise fully on the opportunities presented.

The Markets in Financial Instruments Directive comes into effect on 1 November 2007, when it will replace the existing Investment Services Directive, covering a broader range of investment instruments and market structures and, because conduct of business rules are set at EU level, should mean less additional requirements when passporting into another member state.

UK

In April 2006, the Office of Fair Trading (OFT) concluded its inquiry into credit card terms under the Unfair Terms in Consumer Contracts Regulations, and announced that it did not intend to intervene further where issuers reduced their default fees to £12 or less. Subsequently, the OFT launched an informal high-level fact-finding exercise on overdraft fees, through the industry's representative body, the British Bankers' Association. This is due to conclude in March 2007, following which the industry and the OFT are to review their respective positions. Media interest has been considerable.

The OFT conducted a market study into Payment Protection Insurance (PPI) and referred the PPI market in the UK to the Competition Commission. The Competition Commission recently announced that they will be working with the Financial Services Authority (FSA) to investigate

[Back to Contents](#)

whether there is a case for changing the existing rules for the sale of PPI.

The OFT conducted the follow-up review of the SME market, prescribed by its report published in 2002. HSBC cooperated with this review and awaits the findings.

Following MasterCard's appeal to the Competition Commission Appeals Tribunal, the OFT withdrew its original interchange fee case to concentrate on a new case against both MasterCard and Visa. The European Commission is also investigating interchange fees, and HSBC has responded to its requests for information.

In November the winding down of the Payment Systems Taskforce was announced, and a new governance body for payment systems, the Payments Industry Association, was established. HSBC is positioned to deliver the faster electronic payments introduced by the Payment Systems Taskforce and meets its minimum standards for cheque clearing.

France

Stable interest rates in the eurozone contributed to a strong growth in real estate investment in France. Competition between French banks concentrated on the promotion of real estate mortgage loans, which are the principal means by which new customers in France are acquired. Market activity increased and consumers continued to enjoy improved pricing to the detriment of bank margins.

The payment of interest on sight deposits, authorised from the beginning of 2005, was introduced by one major mutual French bank, albeit linked to a quarterly fee for banking services. Market reaction was muted and, to date, no other leading French bank has followed suit.

From January 2006 the Banque Postale was able to offer real estate lending and financial services, including the sale of investment products manufactured by third party providers. Given the scale of Banque Postale's geographical coverage, this will increase competition in an already competitive market.

The French government reformed the household tax law for 2006/2007, notably introducing a tax exemption on capital gains on equities sold after an eight-year holding period and a cap on total household taxes (including income, wealth and local taxes) at 60 per cent of income. The higher marginal tax rate has been limited to 40 per cent. These reforms will increase disposable income for the wealthier individuals who form one of HSBC France's key customer segments.

At the end of December 2005, French banks were granted approval, as in the UK, to provide equity release mortgages. This will assist customers to invest in real estate and finance consumption.

Hong Kong

There was some improvement in the lending market in 2006, as the stable interest rate environment, liquid market, and moderate cost of borrowing supported growth in consumer spending, and demand for personal loans and credit cards rose in consequence.

Competition remained fierce in traditional mortgage products due to the still subdued property market. Robust equity markets buoyed sales of investment products and also benefited investment-related loans.

The sustained appreciation of the Chinese currency during 2006 had no marked effect on Hong Kong's renminbi deposit business. Instead, funds were attracted to Chinese stocks listed in Hong Kong, notably in relation to some of the substantial Chinese IPOs. Nevertheless, local currency deposits continued to grow rapidly due to rising household incomes.

Rest of Asia-Pacific

(including the Middle East)

The competitive environment in the Rest of Asia-Pacific continued to intensify as international banks focused on targeted sectors in emerging markets in pursuit of higher returns. Local banks also actively expanded their reach and business, both within countries and across borders. Competition remained intense throughout the region in all of the customer groups served by HSBC. Regulations in certain countries act to limit the ability of foreign-owned banks to grow both by acquisition and organically by adding distribution or participating in shared networks with domestic banks. However, in many countries the growing sophistication of the relatively young population and increasing affluence of the middle class continued to provide HSBC with further opportunities for growth.

Banks and non-banks, both local and international, are rapidly building consumer finance and direct banking businesses in a number of countries in the region.

North America

In an already highly competitive US financial services industry, institutions involved in a broad range of financial products and services continued to

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Business Review

(continued)

Competitive environment / Europe

consolidate. Within the banking sector, consolidation continued in 2006, with a greater focus on national networks and retail branch banking.

The Group's principal US subsidiaries, HSBC Bank USA and HSBC Finance, faced vigorous competition from a wide array of financial institutions. These include banks, thrifts, insurance companies, credit unions, mortgage lenders and brokers, and non-bank suppliers of consumer credit and other financial services. Many of these institutions are not subject to US banking industry regulation, unlike HSBC. This gives some of them cost and product advantages and thus increases competitive pressure. HSBC competes by expanding its customer base through portfolio acquisitions or alliances, co-branding opportunities and direct sales channels, by offering a very wide variety of consumer loan products and by maintaining a strong service orientation.

The slowing US housing market has had an adverse effect on sub-prime mortgage originators and lenders, including HSBC. Numerous sub-prime lenders have exited the industry or have announced that they are exploring alternatives. Investment banks have been active purchasers of distressed competitors in an attempt to vertically integrate origination platforms to feed secondary market demands.

The six largest banks in Canada dominate the country's financial services industry. Despite this, the market remains very competitive with comparable financial products and services offered by other banks, insurance companies and other institutions. Merger activity among the largest banks in Canada remains possible but, without such consolidation, growth opportunities for the larger banks will continue to exist mainly outside of Canada.

Latin America

Mexico's financial system remains highly concentrated. Five banks dominate the industry, controlling some 80 per cent of banking assets. Of these five, four (including HSBC) are foreign-owned. In 2006, new banking licences were granted to 13 bank and non-bank institutions. This will increase competition, mainly in customer segments in which banking is currently under-represented. These segments also represent potential growth areas for the existing five major banks in the medium to long term.

There is increasing regulatory pressure on banking and pension management fees and commissions, which has constrained growth in non-funds income. As a result, competition is fierce in consumer lending, as financial institutions seek to build alternative income streams despite difficulties in establishing reliable consumer credit histories. HSBC seeks to differentiate through customer service, and is well positioned to capitalise on economic growth with its extensive branch and ATM network, and growing young customer base.

In Brazil, concentration in the industry increased, with the top ten banking groups accounting for some 70 per cent of assets and 87 per cent of branches at 31 December 2006 (2005: 68 per cent and 86 per cent respectively). These top ten banking groups consist mainly of state-owned, privately owned and large foreign banks (including HSBC), and the most significant change in the Brazilian financial system was the growing market share of the larger privately owned banks through consolidation in the industry and partnerships established with national retailers.

Improvements in the macro-economic environment, particularly in increased solvency and liquidity in the market and in monetary policy, have benefited the consumer through constraining inflationary growth. Notwithstanding persistently high interest rates, consumer borrowing has increased. However, total lending as a

percentage of Gross Domestic Product (GDP) remained low in international terms at 34 per cent. This, together with the fact that within the economically active population an estimated 40 million people have limited access to financial services, indicates that the outlook for further growth is positive.

In Argentina, HSBC's direct competition comes primarily from international financial groups that provide an equivalent range of banking, insurance, pension and annuity products and services. Given the growth experienced over recent years in the Argentine economy, there has been resurgent demand for credit products, coupled with increases in deposits. The strong recovery in consumer confidence is reflected in the level of private sector loans and private deposits that grew by 40 per cent and 22 per cent respectively compared with 2005. The life and annuities market increased by 17 per cent in terms of assets, while pension funds collections increased by 30 per cent.

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

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

	Year ended 31 December		
	2006 US\$m	2005 US\$m	2004 US\$m
Personal Financial Services	1,909	1,932	1,621
United Kingdom	1,496	1,475	1,340
France ¹	174	223	205
Turkey	121	134	29
Other	118	100	47
Commercial Banking	2,234	1,939	1,663
United Kingdom	1,801	1,495	1,258
France ¹	236	278	272
Turkey	50	39	25
Other	147	127	108
Corporate, Investment Banking and Markets²	2,304	2,114	1,668
United Kingdom	1,299	1,186	1,021
France ¹	545	472	337
Turkey	64	92	88
Other	396	364	222
Private Banking	805	539	438
United Kingdom	380	171	135
France ¹	22	7	(22)
Switzerland	305	254	203
Other	98	107	122
Other	(278)	(168)	366
United Kingdom	(185)	(47)	477
France ¹	(107)	(147)	(123)
Turkey	(18)	□	□
Other	32	26	12
Total	6,974	6,356	5,756
United Kingdom	4,791	4,280	4,231
France ¹	870	833	669
Turkey	217	265	142
Switzerland	305	254	203
Other	791	724	511

1 France primarily comprises the domestic operations of HSBC France and the Paris branch of HSBC Bank.

2 Including venture capital gains of US\$457 million (2005: US\$610 million; 2004: US\$170 million).

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

Economic briefing

UK GDP growth increased in 2006 to about 2.7 per cent from 1.9 per cent in 2005. This followed a recovery in both household and company spending. Consumer Price Index (CPI) inflation increased through the year from 1.9 per cent in January to 3.0 per cent in December, following large increases in the price of petrol and gas. The Bank of England raised interest rates from 4.5 per cent to 5 per cent, citing concerns about spare capacity, rapid money growth and the possibility of inflation staying above target for some time. House price inflation remained strong but consumer spending appeared unaffected. Secured lending continued to increase although unsecured lending plateaued. There was evidence

that a number of households were struggling with the burden of debt as personal insolvencies and repossessions increased. Employment rose, although by less than the increase in available workers as migrant inflows remained strong and the participation rate of UK residents in the labour force increased. As a result, the unemployment rate increased, contributing to constrained wage growth throughout the year despite relatively high rates of headline inflation.

The recovery in the **eurozone** economy gathered momentum through the course of 2006. GDP rose by approximately 2.7 per cent, the fastest rate since 2000. Much of the improvement reflected increases in exports and investment, as global demand remained strong and corporate activity and profits rose. Consumer spending remained subdued, despite a gradual rise in employment. German

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Business Review

(continued)

Europe > 2006

Profit before tax

	Year ended 31 December		
	2006 US\$m	2005 US\$m	2004 US\$m
Europe			
Net interest income	8,289	8,221	9,098
Net fee income	7,108	6,299	5,980
Net trading income	4,529	3,036	997
Net income from financial instruments designated at fair value	144	362	□
Net investment income on assets backing policyholders' liabilities	□	□	571
Gains less losses from financial investments	624	439	154
Dividend income	183	63	558
Net earned insurance premiums	1,298	1,599	1,875
Other operating income	1,428	1,603	1,175
Total operating income	23,603	21,622	20,408
Net insurance claims incurred and movement in policyholders' liabilities	(531)	(818)	(1,628)
Net operating income before loan impairment charges and other credit risk provisions	23,072	20,804	18,780
Loan impairment charges and other credit risk provisions	(2,155)	(1,929)	(1,033)
Net operating income	20,917	18,875	17,747
Total operating expenses	(13,871)	(12,639)	(12,028)
Operating profit	7,046	6,236	5,719
Share of profit/(loss) in associates and joint ventures	(72)	120	37
Profit before tax	6,974	6,356	5,756
	%	%	%
Share of HSBC's profit before tax	31.5	30.3	30.4
Cost efficiency ratio	60.1	60.8	64.0
Year-end staff numbers (full-time equivalent)	78,311	77,755	74,861
	US\$m	US\$m	US\$m
Selected balance sheet data¹			
Loans and advances to customers (net)	392,499	312,537	277,560
Loans and advances to banks (net)	76,830	44,360	56,049
Trading assets, financial instruments designated at fair value and financial investments ²	242,010	146,777	139,183
Total assets	828,701	636,703	545,557
Deposits by banks	67,821	47,202	55,720
Customer accounts	419,365	334,200	292,568

- 1 *Third party only.*
- 2 *Including financial assets which may be repledged or resold by counterparties.*

growth improved sharply, while growth in France and Italy was less impressive. Eurozone inflation was heavily affected by rises in energy and food prices. Inflation, excluding energy and food, remained contained at just 1.7 per cent. The European Central Bank (‘‘ECB’’) increased the key policy interest rate from 2.25 per cent at the beginning of 2006 to 3.5 per cent in December. The ECB continued to describe monetary policy as ‘‘accommodative’’, thereby effectively ending the year with a bias towards tightening.

Turkey’s economy slowed markedly in the third quarter, with year-on-year GDP growth of 3.4 per cent, down from 7.8 per cent in the second

quarter. The current account deficit continued to widen, reaching 8 per cent of GDP in December, partly from high-energy prices but also from the increasing substitution of imported materials for local ones due to the overvalued currency. More than half of the deficit was financed by healthy foreign direct investment inflows. The International Monetary Fund’s programme for Turkey remained on track.

Review of business performance

European operations reported a pre-tax profit of US\$6,974 million compared with US\$6,356 million in 2005, an increase of 10 per

[Back to Contents](#)

cent. On an underlying basis, pre-tax profits grew by 8 per cent. Underlying net operating income increased by 9 per cent, in line with operating expenses. Commercial Banking delivered a third successive year of growth, driven by strong balance sheet growth in the UK and organic expansion in Turkey. Record profits in Private Banking were driven by strong client asset inflows, a more sophisticated product mix and lending growth. Corporate, Investment Banking and Markets made encouraging gains in trading activities, and operating expenses rose in line with net operating income. In Personal Financial Services, net operating income growth slowed as HSBC tightened its underwriting criteria on unsecured credit. An emphasis on deposit, wealth and insurance products contributed to an increase in costs, which were driven by infrastructure investment both in the physical environment and direct channels.

The following commentary is on an underlying basis.

Personal Financial Services reported a pre-tax profit of US\$1,909 million, 2 per cent lower than in 2005. Net operating income rose by 4 per cent and loan impairment charges increased by slightly more than revenues as increasing numbers of debtors sought formal protection from their obligations. Costs grew by 7 per cent, reflecting investment in infrastructure throughout the region, and the cost efficiency ratio rose by 1.2 percentage points to 59.2 per cent.

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

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

enhanced to offer personalised content and sales capabilities, with improved customer accessibility.

In France, a marked improvement in brand awareness after the 2005 rebranding to "HSBC France", supported by competitive pricing, aided the recruitment of target customers and consequential balance sheet growth, most notably in residential property lending. Despite this growth, there was a decline in profit before tax, due to competitive pressures on margin and the time lag between incurring costs on customer acquisition and earning incremental revenue from future opportunities to cross-sell.

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

Net interest income increased by 5 per cent to US\$5,653 million, substantially from balance sheet growth throughout the region.

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

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

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

Average UK credit card balances rose by 5 per cent, to US\$13.7 billion, driven by promotional campaigns and marketing. Growth was strongest in

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Business Review

(continued)

Europe > 2006

M&S branded cards, which represented 4 percentage points of the increase, driven by an increased sales focus which included extensive media advertising. This was partly offset by declining balances within the store cards business and the cards business of HFC Bank Ltd (HFC), reflecting HSBC's more restricted credit appetite. Spreads increased modestly compared with 2005.

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

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

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

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

Net fee income increased by 8 per cent to US\$2,533 million. In the UK, rising sales of fee-earning packaged current accounts, travel money and

investment products drove fee growth. Fees from unsecured lending also rose. These benefits were partly offset by lower creditor protection income, reflecting the steps taken by HSBC to constrain lending growth. Reduced loan sales and smaller average loans (the result of this initiative) led to both lower insurance sales and a reduction in average premiums.

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

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

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

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

Loan impairment charges and other credit risk provisions of US\$1,838 million were 6 per cent higher than in 2005, largely reflecting lending growth in the region.

In the UK, the 8 per cent rise in loan impairment charges was broadly in line with lending growth. Actions taken on underwriting and collection activities mitigated a continuation of the rising trend

[Back to Contents](#)

in personal bankruptcies and IVAs seen since the legislative change in 2004. In 2006, IVAs became the main driver of loan impairment growth across the industry as the availability and marketing of third-party debt reduction services increased.

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

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

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

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

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

Commercial Banking reported a pre-tax profit of US\$2,234 million, an increase of 14 per cent compared with 2005. Adjusting for the sale of the UK fleet management and vehicle finance leasing business, which was sold in the autumn of 2005, profit before tax grew by 17 per cent, driven by growth of 10 per cent in net operating income compared with just 4 per cent in costs. Revenues increased by 9 per cent through balance sheet growth, customer recruitment and improved cross-sales in the UK, and expansion of the middle market, small and micro businesses in Turkey. The 4 per cent growth in operating expenses primarily reflected investment to support business expansion throughout the region. Credit quality was stable.

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

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

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

HSBC slowed the rate of growth in lending in the UK during 2006 by refining underwriting criteria and emphasising non-lending related revenue streams and, consequently, average lending balances rose by 8 per cent during the year and spreads remained broadly flat. Increased priority was given

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Business Review

(continued)

Europe > 2006

to raising deposits through transactional and savings accounts and, as a result, deposit balances rose by 37 per cent and current account balances by 8 per cent. The benefit of this volume growth was partly offset by spread compression on sterling-denominated accounts as customers were offered more attractive pricing.

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

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

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

Net fee income increased by 4 per cent to US\$1,707 million. Current account and money transmission fees rose as a result of customer recruitment and higher transaction volumes in most countries. In the UK, client workshops and other promotional activities were deployed to support increased sales of treasury products, boosting treasury revenue as foreign exchange volumes grew. In France a 2 per cent increase in income was largely in transactional current account fees, reflecting growth in the customer base.

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

Credit quality in Commercial Banking was stable in most countries. In the UK, loan impairment charges and other credit risk provisions fell by 16 per cent, largely due to the non-recurrence of an individual loan impairment allowance against a single customer in 2005. Excluding this, there was a modest decline in UK impairment charges, as the effect of lending growth was more than offset by improved credit quality, particularly in relation to HSBC's larger exposures. In France, loan impairment charges, while remaining low, returned to a more normal level after relatively high recoveries in 2005. In Turkey, higher loan impairment charges reflected growth in lending.

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

and micro businesses drove a 38 per cent rise in expenses.

Corporate, Investment Banking and Markets reported a pre-tax profit of US\$2,304 million, an increase of 5 per cent, compared with 2005. A reduction in recoveries of loan impairment charges and lower private equity gains masked strong growth in core operating activities. Global Markets' revenues were 36 per cent higher than in 2005 as robust performances in the global capital markets and securities services businesses were complemented by strong trading gains. The cost efficiency ratio improved modestly compared with 2005.

Total operating income was US\$6,560 million, 17 per cent higher than in 2005. This was despite the fact that in the UK, France and Turkey, balance sheet management revenues continued to fall, resulting in an overall decline of 56 per cent. This shortfall was partly offset by higher net interest income in HSBC Securities Services as customer volumes grew in higher-value products such as securities lending and foreign exchange. The lending business delivered a 13 per cent increase in corporate balances and corporate spreads remained broadly in line with 2005.

[Back to Contents](#)

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

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

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

Trading income increased with positive revenue trends in the key product areas where HSBC has invested, notably Credit and Rates, foreign exchange and structured derivatives. Revenues increased substantially, particularly in the area of interest rate derivatives, which benefited from opportunities created by a relatively volatile market. Additional gains were reported in emerging market bonds due to higher volumes, as investors adjusted their risk appetite and responded to a general improvement in market sentiment towards developing economies. Higher foreign exchange revenue was driven by greater customer volumes and increased trading opportunities offered by a combination of US dollar volatility and more uncertain economic conditions in emerging markets. Structured derivatives income increased by 88 per cent as HSBC leveraged its investment in this business to meet the needs of its institutional clients.

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

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

The overall credit environment remained favourable with market liquidity supporting debt reconstruction as credit spreads tightened. As a result, HSBC achieved net recoveries for the third year in succession, albeit at a lower level than in

2005, when HSBC benefited from a release of collective impairment allowances in the second half.

Operating expenses were 14 per cent higher at US\$4,224 million, largely supporting volume growth in various businesses and performance-related compensation in Global Markets, where revenues increased by 36 per cent. Costs in 2006 also reflected the full-year effect of the investment made throughout 2005 as well as ongoing investment in product development, particularly in structured derivatives and Credit and Rates. In Group Investment Businesses, a robust performance resulted in higher staff and support costs.

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

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

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

referrals with other customer groups was encouraging and also contributed to increased revenues.

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

Fee income increased by 19 per cent to US\$869 million. This growth resulted from increased funds under management and a favourable

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Business Review

(continued)

Europe > 2006

mix change towards higher fee-generating discretionary and advisory managed funds, including the continued success of the SIS and CIS products and the launch of the "Actively Managed Portfolio" product. A significant performance fee came from the Hermitage Fund, a public equity fund dedicated to Russia, which was US\$23 million greater than in 2005. The expansion of HSBC's residential property advisory business, which opened new offices in the UK and France, also contributed to fee income growth.

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

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

Client assets, including deposits, rose by 18 per cent to US\$218 billion. Net new money was US\$19 billion, with the largest inflows arising in Switzerland and the UK. In Switzerland, improved brand awareness, successful product placement and cross-referrals with other customer groups, all contributed to significant net new money of US\$11 billion. In the UK, net new money of US\$3 billion was garnered from referrals from Commercial Banking and the retail network, new regional offices and continued growth in the underlying business. Net new money in Monaco and Germany exceeded US\$1 billion and US\$2 billion, respectively, also contributing to the growth in client assets. The value of clients' investments in HSBC's discretionary managed suite of SIS and CIS products grew very strongly, reaching US\$1.7 billion. Operating expenses were 13 per cent higher than in 2005 due to higher performance-related remuneration, recruitment of client-facing professionals across the region to support the growth of the business, and continued investment in the recently opened UK regional offices. The combination of HSBC's principal trust businesses in Switzerland also added to costs in 2006 but is expected to bring efficiency gains in subsequent years. Overall increased expenses were more than offset by greater revenue generation which contributed to the 6.7 per cent improvement in the cost efficiency ratio.

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

Movements in the fair value of own debt and associated hedges were US\$33 million, compared with an adverse movement of US\$15 million in 2005, principally from movements in HSBC's own credit spread. The fair value of own debt incorporates an element attributable to the credit spread on HSBC's debt instruments. As HSBC's credit spreads narrow, accounting losses are reported, and the reverse is true in the event of spreads widening. These valuation adjustments do not alter the cash flows envisaged as part of the documented interest rate management strategy.

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

Year ended 31 December 2005 compared with year ended 31 December 2004

Economic briefing

Growth in the **UK** economy remained subdued during 2005 at 1.9 per cent, the lowest rate since 1992. Consumer spending and housing activity slowed sharply during the first nine months of the year, staging a minor recovery

in the final quarter. Doubts remained over the strength of consumer spending, given the rise in unemployment in ten consecutive months and reduced confidence in the housing market. The boost to the economy from government spending in recent years was also not expected to be as significant. The recovery in exports was maintained, helped in large part by the strength of the global economy, though the industrial sector continued to struggle. Industrial output contracted in 2005 for the fourth time in the past five years. Companies remained reluctant to invest despite a general profit recovery, stronger balance sheets and an impressive equity market performance. Although commodity prices rose sharply, inflation remained well contained at around 2 per cent and wage growth eased. In response to weaker economic activity, the Bank of England cut interest rates in August to 4.5 per cent.

The **eurozone** experienced lacklustre economic growth in 2005 of 1.4 per cent, although momentum accelerated during the course of the year. With consumer spending growth remaining subdued, the strongest areas were exports and fixed investment. There was, as usual, considerable divergence between countries: Italy and Portugal saw hardly any economic growth while Spain, Greece and Ireland grew by over 3 per cent. Growth in France slowed from 2.1 per cent in 2004 to 1.4 per cent in 2005 but both investment and consumer spending revived a little in the second half of the year. Weak domestic

[Back to Contents](#)

demand continued to constrain German GDP growth, which slowed from 1.1 per cent in 2004 to 0.9 per cent in 2005, despite a strong increase in exports, particularly capital goods. Eurozone inflation averaged a little over 2 per cent in 2005, with higher energy prices boosting inflation by around 0.5 per cent. The European Central Bank raised interest rates from 2.0 per cent to 2.25 per cent in early December, the first increase for almost five years.

The performance of the **Turkish** economy in 2005 remained very positive. GDP grew by approximately 5.5 per cent, while inflation continued to fall, to 7.7 per cent in December from 9.7 per cent a year earlier. Economic policy remained anchored by the government's agreement with the IMF. Turkey's current account deficit, which reached US\$23.1 billion, or approximately 6.3 per cent of GDP in 2005, is increasingly being financed by longer-term foreign direct investment into the country, which should help reduce Turkey's vulnerability to a sudden reversal in short-term capital flows.

Review of business performance

European operations reported a pre-tax profit of US\$6,356 million compared with US\$5,756 million in 2004, an increase of 10 per cent. IFRSs changes to the treatment of preference share dividends led to a US\$275 million reduction in pre-tax profits. On an underlying basis, pre-tax profits grew by 25 per cent and represented around 30 per cent of HSBC's equivalent total profits. In the UK, strong revenue growth in Personal Financial Services and good cost discipline were partially tempered by a weaker credit experience. A quadrupling of pre-tax profits in Turkey reflected the strong growth in customer acquisition and retention achieved in the country. In Commercial Banking, HSBC's strong service proposition attracted a 5 per cent growth in customers with consequent growth in deposits, receivables and service revenues. Corporate, Investment Banking and Markets delivered strong revenue growth in Europe, notably in client-related trading activities, Global Transaction Banking and securities services. In aggregate, European Corporate, Investment Banking and Markets' revenues grew by 15 per cent against a 9 per cent increase in operating expenses.

The commentary that follows is on an underlying basis.

Personal Financial Services reported a pre-tax profit of US\$1,932 million, an increase of 16 per cent compared with 2004, driven by revenue growth

and productivity improvements in the UK and expansion in Turkey, where pre-tax profit more than quadrupled to US\$134 million. In France, revenue growth benefited from the rebranding of CCF and four subsidiary banks to HSBC France, with a notable increase in international products, particularly mortgage lending to overseas customers.

Continued emphasis was placed on streamlining the business to improve productivity, and on sales and channel management, particularly in the UK, where one third of sales were made through direct channels in 2005. Attention was also paid to further simplifying HSBC's product range in the UK, and on integrating the Marks and Spencer (M&S) Money business in its first full year since acquisition. A number of innovative marketing campaigns and promotions during 2005 heightened brand awareness, leading to greater customer consideration of HSBC products. This was evidenced in strong balance growth and market share gains across most major product lines. In Turkey, an emphasis on business expansion and customer acquisition delivered increased card sales and utilisation combined with higher mortgage sales. In France, marketing campaigns in conjunction with the rebranding exercise boosted mortgage lending and sales of insurance and investment products.

Net interest income increased by 10 per cent to US\$5,309 million. This arose substantially in the UK through increases in mortgage and credit card lending, and in Turkey, mainly in credit cards. Increased net interest income from balance sheet growth in France was offset by spread compression.

Despite a more subdued housing market, net interest income from UK mortgages increased by 37 per cent, driven by balance growth of 22 per cent and improvements in customer retention. Spreads also increased, reflecting the inclusion from 1 January 2005 of fee income within the effective interest rate calculation under IFRSs. New lending was strongest in the first time buyer market, where successful pricing and marketing strategies helped gain market share of new sales in a market which contracted overall.


Net interest income from UK credit cards increased by 24 per cent, driven by balance growth and the IFRSs impact noted above. Increased card utilisation by existing customers, as well as new customers attracted by competitive pricing, marketing and cross-sales, contributed to an increase of 16 per cent in average balances. HSBC-branded cards increased market share of new cards issued; sales of the John Lewis branded credit card also increased. Income benefited from the roll-off of

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Business Review

(continued)


Europe > 2005

balance transfers introduced in the 0 per cent campaign at the end of 2004, while more sophisticated risk-based pricing enabled customer rates to be differentiated more acutely.

Net interest income from other unsecured lending in the UK increased by 4 per cent. The launch of differentiated pricing initiatives in April, notably through preferential personal lending rate offers to lower-risk customers, helped boost average loan balances by 9 per cent, and increase HSBC's market share of gross advances from 10.7 to 11.7 per cent. Focused sales and marketing, notably the January sale, also contributed to higher balances. As indebtedness levels grew, growth was curtailed through a tightening of underwriting criteria in the more difficult credit environment. The introduction of preferential pricing, and a mix change towards higher value but lower-yielding loans, led to a 48 basis point narrowing of spreads.

Recruitment of new current account customers was strong, and HSBC's market share of new current accounts increased to 14.7 per cent, largely through brand-led awareness and marketing. The launch of two new current account propositions, including HSBC's first value-driven packaged account in the UK market, and improved cross-sales aided growth of 6 per cent in overall customer accounts. This led to an increase in net interest income from UK current accounts of 5 per cent to US\$1.0 billion, broadly in line with the 6 per cent increase in average balances.

Sales of new UK savings accounts increased markedly, and average balances rose by 15 per cent, driven by a greater front-line focus, competitive pricing and the launch of new products, including Regular Saver and Online Saver. Included in this was growth of over US\$1.2 billion in First Direct's e-savings product, launched in September 2004. Net interest income, however, fell by 5 per cent, largely due to the non-recurrence of the benefit to spreads from base rate rises in 2004, and a slight reduction in margin. The latter arose from competitive pricing initiatives partly designed to improve brand awareness and widen product consideration.

In Turkey, innovative marketing initiatives and advertising campaigns, with an emphasis on attracting new customers, contributed to strong growth in net interest income, which more than doubled compared with 2004. Average card balances increased by 66 per cent to US\$0.9 billion, and average mortgage balances more than doubled to US\$0.6 billion. Higher card usage by existing customers, higher average mortgage advances and a

7 per cent increase in overall customer numbers contributed to the growth.

In France, net interest income was broadly in line with 2004. Marketing campaigns in the run-up to the rebranding exercise contributed to a 54 per cent increase in mortgage sales in a buoyant market, and a resultant 18 per cent increase in average balances. Cross-sales of current and special regulated savings accounts were strong, and average deposit balances grew by 4 per cent to US\$14.9 billion. The benefit of this balance sheet expansion was largely offset by lower spreads, as competitive pricing reduced yields on lending products, and the maturing of older, higher-yielding investments reduced the funding benefit from deposits.

Excluding net interest income, net operating income before loan impairment charges grew by 16 per cent to US\$3,386 million, of which 12 percentage points was in the UK and largely attributable to increased fees associated with the increase in personal lending, mortgage and credit card volumes described above. Increased card utilisation also led to higher cash advance fees and currency conversion income. An improved investment fund offering, following the depolarisation of the previously tied sales force, was reflected in a 5 per cent increase in related commissions. In Turkey, fee income benefited from increased lending activity. In France, privatisations boosted brokerage income, and new product launches and marketing aided growth in insurance and investment sales.

Under IFRSs, changes in presentation from 1 January 2005, notably for certain contracts previously accounted for as insurance, and with the designation of insurance-related assets at fair value, caused large movements within certain individual income lines. These had a negligible effect on income overall. There was also a US\$32 million gain from the fair value measurement of options linked to French home-savings products.

Loan impairment charges of US\$1,711 million were 73 per cent higher than 2004, the majority of which occurred in the UK. In large part, this reflected the strong growth in higher margin credit card and other unsecured lending in recent years. Weakening economic conditions and sharply rising personal bankruptcies, following the change in legislation in 2004, were also significant contributors.

Loan impairment charges as a percentage of period end net customer advances rose from 0.8 per cent to 1.4 per cent.

[Back to Contents](#)

HSBC responded to the weaker UK credit environment by further refining its credit eligibility criteria, and by enhancing its credit scorecards with full positive credit reference data. HSBC became the first UK high street clearing bank to share full customer credit performance data in 2005.

Underwriting activity was also further centralised. Collections capabilities were enhanced, resulting in an increase in amounts collected, and resources were added to the Retail Credit Risk Management function. As a result, lending activity in the second half of the year indicated that the credit quality of more recent unsecured lending had improved.

Higher charges in Turkey were broadly in line with balance sheet growth, while credit quality in France remained sound.

Operating expenses were largely unchanged from 2004. The 7.5 percentage point fall in the cost efficiency ratio, to 58 per cent, was largely driven by productivity improvements in the UK. This reflected the benefits of the cost reduction strategy introduced in 2004. Increased focus on direct channels, and the greater centralisation of support functions enabled by this, reduced the UK cost base in 2005, which also benefited from the non-recurrence of the restructuring costs incurred in implementing this strategy. Costs in 2004 also included amounts for compensation expected to be payable to UK customers for shortfalls on certain mortgage endowment policies and investment products. Operating expenses in 2005 included the initial phase of a UK branch refurbishment programme designed to improve customer experience, which added US\$73 million to costs.

In France, a 2 per cent increase in operating expenses was driven by the recruitment of additional sales staff, as well as the rebranding exercise and associated marketing expenditure. In Turkey, marketing costs increased by 30 per cent and staff costs by 33 per cent, largely in support of the growing credit card business.

Commercial Banking reported a pre-tax profit of US\$1,939 million, an increase of 18 per cent. In highly competitive markets, revenues grew by 6 per cent and profit improvement largely reflected reduced costs, more than offsetting higher loan impairment charges.

In the UK, improved market segmentation led to a more acute focus on the needs of individual customers and underpinned a 20 per cent increase in pre-tax profits. The establishment in 2004 of Corporate Banking Centres to improve the service offered to MMEs, and Commercial Centres focusing on larger SMEs, together with the recruitment of

additional sales staff, contributed to a 6 per cent increase in customers and strong growth in lending. Revenues responded strongly, and costs were lower following a reorganisation in the UK in 2004 to improve efficiency. UK credit quality experienced some weakening in the fourth quarter of 2005, reflecting higher interest rates and the resulting slowdown in consumer spending. However, the quality of HSBC's commercial lending book remained strong overall with impairment charges continuing to run below historical levels: as in prior periods, loan impairment charges principally reflected allowances against a small number of accounts.

Net interest income increased by 16 per cent. In the UK, lending and overdraft balances increased by 23 per cent, or US\$6.6 billion, as a result of strong customer demand. HSBC increased its lending market share, with particularly strong growth in the property, distribution and services sectors. In invoice financing, a 12 per cent increase in customer numbers supported by a sales force realignment led to higher balances and a 10 per cent increase in net interest income. Risk-based pricing improved overdraft spreads by 15 basis points, while term lending margins were in line with 2004.

A campaign designed to secure a greater share of the commercial savings market, in part through more competitive pricing, contributed to an 11 per cent increase in UK deposit balances, with spreads falling by 16 basis points. Overall, UK commercial customer liability balances benefited from both deposit growth and a 12 per cent increase in current account balances. Current account customer numbers rose to over 700,000 with over 20,000 customers switching their business to HSBC following marketing and advertising campaigns in 2005. In the UK, HSBC attracted over 90,000 start-up accounts, representing a 20 per cent market share. Spreads on sterling current accounts fell as customers continued to migrate to interest-paying current accounts. Increases in US interest rates led to a widening of spreads on international and foreign currency current accounts.

Net interest income in Turkey increased by 29 per cent, principally as a result of higher lending and deposit balances, which increased by 25 per cent and 19 per cent respectively. HSBC deepened its relationships with its larger commercial banking customers and recruited additional sales staff to support the launch of SME banking in the second half of 2005.

In France, increased marketing activity highlighting HSBC's international capabilities as

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Business Review

(continued)

Europe > 2005

CCF rebranded to HSBC France, together with a programme to align the bank's 350 largest Commercial Banking customers with the most experienced relationship managers, led to a 10 per cent increase in medium term loan balances. Sight deposit balances grew by 7 per cent, though deposit spreads decreased as maturing funds were placed at lower prevailing interest rates.

Net fee income increased by 2 per cent to US\$1,621 million, net of IFRSs changes to switch some fees into the effective interest rate calculation, which led to a 15 per cent reduction in fee income. In the UK, higher new business volumes and lending activity contributed to a US\$77 million, or 27 per cent, increase in loan and overdraft fee income. Increased customer numbers, coupled with the introduction of a new small business tariff in January 2005, led to a 13 per cent increase in current account fee income. Card acquiring income increased by 8 per cent, despite a slowdown in consumer spending driven by a 6 per cent increase in transaction volumes, reflecting merchant acquisition. A 21 per cent increase in card customer numbers contributed to higher card issuing income.

HSBC benefited from the recruitment of additional sales staff, development of profitable relationships with brokers and the success of dedicated corporate and commercial centres. Invoice financing fee income increased by 9 per cent, benefiting from an expanded client base, while a tariff review contributed to a 16 per cent increase in treasury income. The recruitment, in both 2004 and 2005, of commercial independent financial advisers, together with the development of existing sales staff, led to a 13 per cent increase in insurance and investment income, with fee income from savings and investment products increasing by a third. Income in the vehicle and equipment leasing businesses decreased by 13 per cent, following an agreement to outsource the operational functions of the UK vehicle finance contract hire business to Lex Vehicle Leasing, which took effect from November 2005. Excluding the transfer, net fee income from leasing increased by 5 per cent.

Loan impairment charges and other credit risk provisions increased by 26 per cent to US\$378 million. In the UK, lending growth and sizeable allowances against a small number of accounts led to a US\$162 million increase in charges. Overall credit quality remained relatively strong, although some deterioration was evident in the market in the last three months of 2005 as consumer spending declined. In France, new individually assessed allowances were largely offset by higher recoveries, while in Malta net releases

decreased as a large release against a single customer in 2004 was not repeated.

Operating expenses decreased by 5 per cent and, together with increased income, resulted in a 6 percentage point improvement in the cost efficiency ratio. In the UK, the non-recurrence of cost reduction expenditure in 2004, together with the resulting fall in staff numbers and strong cost control, contributed to a 10 per cent decrease in operating expenses. Although overall staff numbers declined, additional sales staff were hired to take advantage of business opportunities in support of revenue growth. These sales staff were supported by press and other advertising campaigns aimed at attracting customers switching banks and start-up businesses to HSBC, together with a campaign targeting SMEs which contributed to an increase in marketing costs.

In France, staff recruitment, increased marketing activity and re-branding led to an 8 per cent increase in costs. Staff costs rose as HSBC France recruited additional sales staff to support business expansion, and success led to higher performance-related remuneration. Campaigns targeting top tier commercial customers and supporting product launches led to an increase in marketing expenditure, while rebranding and supporting activity to emphasise the "HSBC" name change also contributed.

In an economy which grew by 5.5 per cent in 2005, increased business activity, the launch of SME banking and the recruitment of additional sales and support staff in Turkey contributed to a rise in income and a 17 per cent increase in operating expenses.

Corporate, Investment Banking and Markets reported a pre-tax profit of US\$2,114 million, an increase of 27 per cent, compared with 2004. Revenues from all major client-related trading activities increased, particularly from the credit and rates, equities and structured derivatives businesses where HSBC has invested in upgrading its capabilities. Operating expenses rose, reflecting the first full-year cost of the expanded sales and execution capabilities. However, cost growth slowed in the second half of 2005 and in aggregate in Europe, revenue growth comfortably surpassed growth in costs. In Europe, 2005 marked the transition from the investment phase of Corporate, Investment Banking and Markets' development strategy to a focus on implementation.

Total operating income increased by 15 per cent to US\$5,510 million. Balance sheet management and money market revenues declined by approximately

[Back to Contents](#)

46 per cent reflecting a challenging interest rate environment of higher short-term rates and a flattening yield curve.

Corporate lending spreads remained under pressure as customers refinanced and negotiated better terms in response to falling credit spreads on virtually all publicly traded debt instruments and strong liquidity in the banking system. In the UK, the adverse impact of a 23 basis point decrease in spreads on customer lending was partly mitigated by a 7 per cent increase in lending balances. Corporate and Institutional Banking also implemented a balance sheet securitisation programme to enhance returns. In Global Transaction Banking, net interest income increased, primarily due to an increase in balances held on behalf of customers, coupled with the favourable impact of rising short-term rates. Customer deposit balances increased by 23 per cent and spreads improved by 9 basis points.

Net fees rose by 7 per cent, partly due to an increase in earnings from the equity capital markets business. Additionally, as equity markets became more buoyant, HSBC Securities Services fees increased and assets under custody grew by 15 per cent to US\$3,242 billion, primarily due to new business and market value appreciation. The asset-backed securities product also generated higher fees with several notable transactions closing in 2005. In Germany, a 31 per cent rise in net fees was driven by origination activity and higher sales of structured solutions.

The increase in income from trading activities arose from positive revenue trends on core products within Global Markets in response to the investment made in client-facing trading capabilities. Fixed income revenues were boosted by higher volumes processed through electronic trading platforms and by the expansion of primary dealing activity in European government bond markets. In the UK, a strong performance in structured derivatives reflected investment in new hybrid derivatives and structured fund derivatives businesses, while income in the credit and rates business rose by 25 per cent as a result of higher revenues from securities trading, asset-backed securities and credit default swaps. There was growth in income from currency derivatives on the back of increasing client business.

Other income was boosted by gains from the restructuring and syndication of existing assets in Global Investment Banking.

Gains from sales of financial investments increased significantly to US\$396 million, due to higher realisations from Private Equity.

The overall credit environment remained favourable, with a net recovery in 2005 as in 2004. There were, however, lower recoveries of loan impairment charges in the UK and France, as HSBC had benefited from a number of successful refinancings in 2004. In Italy, a net recovery reflected relatively lower allowances against loan impairment, coupled with releases of provisions made in 2004.

Operating expenses increased by 9 per cent to US\$3,647 million, partly from the first full year effect of recruitment in 2004 and partly from a further 980 people recruited in 2005 to deliver the expanded capabilities reflected in the revenue gains described above. Extensive investment was also made to develop the infrastructure and technology platform required to integrate and support the business expansion. In Global Markets, costs rose as new capabilities were added to the cash equities platform, the structured derivatives business in the UK and the credit and rates business. An increase in operational costs, particularly in Global Transaction Banking, was due to higher transaction volumes.

Private Banking reported a pre-tax profit of US\$539 million, an increase of 23 per cent compared with 2004, driven by strong growth in client assets, transaction volumes and the lending book. Operating expenses rose with a recruitment-driven increase in staff costs partly offset by efficiency savings and the non-recurrence of restructuring costs in France in 2004.

Net interest income increased by 31 per cent, driven by strong balance sheet growth in the UK, Switzerland and, to a lesser extent, Germany. Overall, lending balances increased by 21 per cent to US\$16.7 billion, as clients borrowed in the low interest rate environment to make alternative investments. This included strong growth in UK mortgage balances, which increased by 39 per cent, in part reflecting synergies with HSBC's residential

property advisory business. Deposits increased by 20 per cent to US\$38.6 billion, as new clients placed cash prior to investment.

Client assets, including deposits, increased by 22 per cent to US\$174.7 billion. Net new money of US\$23.4 billion reflected notably strong inflows in Switzerland, Germany, Monaco and the UK. In Switzerland, an increased marketing effort and successful product placement aided net new money of US\$9.6 billion. In Germany, US\$7.6 billion of new money was predominantly due to the success of a new wealth management team. In Monaco, a focus on building the onshore business generated inflows of US\$4.1 billion, while in the UK, cross-referrals

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Business Review

(continued)

Europe > 2005 / Profit/(loss) before tax

with the wider Group contributed to nearly one quarter of the US\$1.6 billion of new money.

A US\$20 million lower performance fee from a public equity fund dedicated to Russia was more than offset by increased core fees and commissions in line with growth in client assets, and transactional income as new clients invested. Higher fee income also reflected growth in discretionary and advisory managed assets, and volume growth, which was boosted by the success of new products launched in 2005, notably in alternative investments. Gains from financial investments in both 2004 and 2005 were mainly on the sale of debt instruments. The overall gain in 2005 of US\$27 million was 17 per cent lower than in the previous year.

The net release of loan impairment charges in 2005 related largely to specific clients; improved credit quality overall also led to a release of collective impairment provisions.

Operating expenses rose by 11 per cent, of which front office recruitment and increased performance-related remuneration comprised 4 and 5 percentage points respectively. Investment costs, largely in IT and marketing, and supporting business growth contributed further to the increase. These were in part offset by back office efficiency savings and lower restructuring costs following 2004's merger of HSBC's four French private banks.

Within **Other**, net operating income benefited from the change to the presentation of inter-company preference share dividends received from Hong Kong under IFRSs from 1 January 2005. Head office operating expenses increased, reflecting higher brand advertising and marketing costs, increased professional fees incurred to comply with additional regulatory requirements including Sarbanes-Oxley and Basel II, and restructuring costs. In 2004, operating expenses benefited from the release of litigation provisions.

[Back to Contents](#)

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

Year ended 31 December 2006

Europe	Personal Financial Services US\$m	Commercial Banking US\$m	Corporate, Investment Banking & Markets US\$m	Private Banking US\$m	Other US\$m	Inter- segment elimination US\$m	Total US\$m
Net interest income	5,653	2,923	1,222	675	14	(2,198)	8,289
Net fee income	2,533	1,707	1,673	869	326	□	7,108
Trading income/(expense) excluding net interest income	119	27	2,636	99	(39)	□	2,842
Net interest income/(expense) on trading activities	(6)	15	(523)	2	1	2,198	1,687
Net trading income/(expense)	113	42	2,113	101	(38)	2,198	4,529
Net income from financial instruments designated at fair value	80	27	11	□	26	□	144
Gains less losses from financial investments	37	22	413	149	3	□	624
Dividend income	2	3	171	5	2	□	183
Net earned insurance premiums.	979	110	□	□	209	□	1,298
Other operating income	128	103	957	13	256	(29)	1,428
Total operating income	9,525	4,937	6,560	1,812	798	(29)	23,603
Net insurance claims ¹	(331)	(19)	□	□	(181)	□	(531)
Net operating income before loan impairment charges and other credit risk provisions	9,194	4,918	6,560	1,812	617	(29)	23,072
	(1,838)	(386)	64	2	3	□	(2,155)

Loan
impairment
(charges)/
recoveries and
other
creditrisk
provisions

Net operating income	7,356	4,532	6,624	1,814	620	(29)	20,917
Total operating expenses	(5,447)	(2,298)	(4,224)	(1,010)	(921)	29	(13,871)
Operating profit/(loss)	1,909	2,234	2,400	804	(301)	□	7,046
Share of profit/(loss) in associates and joint ventures	□	□	(96)	1	23	□	(72)
Profit/(loss) before tax	1,909	2,234	2,304	805	(278)	□	6,974

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

Selected balance sheet data²

Loans and advances to customers (net)	147,507	81,430	140,277	23,283	2		392,499
Total assets	174,865	98,073	502,340	49,440	3,983		828,701
Customer accounts	152,411	80,312	139,416	47,223	3		419,365

The following assets and liabilities were significant to Corporate, Investment Banking and Markets:

□ loans and advances to banks (net)	63,788
□ trading assets, financial instruments designated	219,304

at fair value,
and financial
investments
deposits by
banks

65,963

45

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Business Review

(continued)

Europe > Profit/(loss) before tax

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

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

charges and other credit risk provisions							
Loan impairment (charges)/ recoveries and other credit risk provisions	(1,711)	(378)	155	5	□	□	(1,929)
Net operating income	6,984	4,233	5,665	1,430	779	(216)	18,875
Total operating expenses	(5,058)	(2,301)	(3,647)	(891)	(958)	216	(12,639)
Operating profit/(loss)	1,926	1,932	2,018	539	(179)	□	6,236
Share of profit in associates and joint ventures	6	7	96	□	11	□	120
Profit/(loss) before tax	1,932	1,939	2,114	539	(168)	□	6,356
	%	%	%	%	%		%
Share of HSBC's profit before tax	9.2	9.2	10.1	2.6	(0.8)		30.3
Cost efficiency ratio	58.2	49.9	66.2	62.5	122.9		60.8
	US\$m	US\$m	US\$m	US\$m	US\$m		US\$m
Selected balance sheet data ²							
Loans and advances to customers (net)	120,302	66,965	107,899	17,368	3		312,537
Total assets	143,095	80,864	367,893	40,971	3,880		636,703
Customer accounts	122,118	61,789	109,086	41,206	1		334,200
The following assets and liabilities were significant to Corporate, Investment Banking and Markets:							
loans and advances to							
□ banks (net)			34,218				
□ trading assets, financial instruments designated at fair value, and financial investments			168,062				
□			45,075				

deposits by
banks

46

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[Back to Contents](#)

Year ended 31 December 2004

	Personal Financial Services US\$m	Commercial Banking US\$m	Corporate, Investment Banking & Markets US\$m	Private Banking US\$m	Other US\$m	Inter- segment elimination US\$m	Total US\$m
Europe							
Net interest income	4,644	2,305	1,403	421	325	□	9,098
Net fee income	2,110	1,593	1,261	658	358	□	5,980
Trading income	□	116	735	104	42	□	997
Net investment income/ (expense) on assets backing policyholders'□ liabilities	445	127	□	□	(1)	□	571
Gains less losses from financial investments	□	1	122	33	(2)	□	154
Dividend income/(expense)	□	36	526	5	(9)	□	558
Net earned insurance premiums .	1,254	409	12	□	200	□	1,875
Other operating income	26	285	770	19	255	(180)	1,175
Total operating income	8,479	4,872	4,829	1,240	1,168	(180)	20,408
Net insurance claims ¹	(1,026)	(487)	□	□	(115)	□	(1,628)
Net operating income before loan impairment charges and other credit risk provisions	7,453	4,385	4,829	1,240	1,053	(180)	18,780
Loan impairment (charges)/ recoveries and other credit risk provisions	(939)	(306)	207	4	1	□	(1,033)
Net operating income	6,514	4,079	5,036	1,244	1,054	(180)	17,747
Total operating expenses	(4,898)	(2,422)	(3,380)	(806)	(702)	180	(12,028)
Operating profit	1,616	1,657	1,656	438	352	□	5,719
Share of profit in associates and joint ventures	5	6	12	□	14	□	37
Profit before tax	1,621	1,663	1,668	438	366	□	5,756
	%	%	%	%	%		%
Share of HSBC's profit before tax	8.6	8.8	8.8	2.3	1.9		30.4
Cost efficiency ratio	65.7	55.2	70.0	65.0	66.7		64.0

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	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m
Selected balance sheet data ²						
Loans and advances to customers (net)	118,796	67,458	75,628	15,676	2	277,560
Total assets	143,515	83,289	273,906	40,140	4,707	545,557
Customer accounts	121,599	57,798	78,031	35,140	□	292,568
The following assets and liabilities were significant to Corporate, Investment Banking and Markets:						
loans and advances to						
□ banks (net)			47,802			
□ trading assets, financial instruments designated at fair value, and financial investments			116,492			
□ deposits by banks			53,646			

1 *Net insurance claims incurred and movement in policyholders' liabilities.*

2 *Third party only.*

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Business Review

(continued)

*Hong Kong > 2006***Hong Kong**

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

	Year ended 31 December		
	2006 US\$m	2005 US\$m	2004 US\$m
Personal Financial Services	2,880	2,628	2,063
Commercial Banking	1,321	955	904
Corporate, Investment Banking and Markets	955	922	1,603
Private Banking	201	190	131
Other	(175)	(178)	129
	5,182	4,517	4,830

Profit before tax

	Year ended 31 December		
	2006 US\$m	2005 US\$m	2004 US\$m
Net interest income	4,685	4,064	3,638
Net fee income	2,056	1,674	1,703
Trading income	617	546	659
Net income/(expense) from financial instruments designated at fair value	260	(6)	□
Net investment income on assets backing policyholders' liabilities	□	□	314
Gains less losses from financial investments	162	108	175
Dividend income	61	41	27
Net earned insurance premiums	2,628	2,334	2,247
Other operating income	834	805	536
Total operating income	11,303	9,566	9,299
Net insurance claims incurred and movement in policyholders' liabilities	(2,699)	(2,059)	(2,154)
Net operating income before loan impairment charges and other credit risk provisions	8,604	7,507	7,145
Loan impairment (charges)/recoveries and other credit risk provisions	(172)	(146)	220
Net operating income	8,432	7,361	7,365
Total operating expenses	(3,269)	(2,867)	(2,558)
Operating profit	5,163	4,494	4,807
Share of profit in associates and joint ventures	19	23	23

Profit before tax	5,182	4,517	4,830
	%	%	%
Share of HSBC's profit before tax	23.5	21.5	25.5
Cost efficiency ratio	38.0	38.2	35.8
Year-end staff numbers (full-time equivalent)	27,586	25,931	25,552
	US\$m	US\$m	US\$m
Selected balance sheet data¹			
Loans and advances to customers (net)	84,282	83,208	78,824
Loans and advances to banks (net)	50,359	42,751	45,710
Trading assets, financial instruments designated at fair value, and financial investments	103,734	81,631	75,721
Total assets	272,428	235,376	225,336
Deposits by banks	4,799	4,708	4,325
Customer accounts	196,691	173,726	178,033

¹ *Third party only.*

[Back to Contents](#)

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

Economic briefing

Hong Kong experienced sustained economic expansion in the second half of 2006 with growth, particularly in exports, regaining momentum following a mild slowdown in the second quarter. Domestic demand underpinned the economy throughout 2006 despite volatility in the stock market, which suffered a correction in the second quarter but recovered strongly in the second half of the year. Falling unemployment, improved household incomes and positive longer-term economic prospects were the key elements supporting domestic consumption. Hong Kong's unemployment rate fell to a six-year low of 4.4 per cent towards the end of 2006, and the labour market began to tighten in certain sectors, with wage pressure increasingly evident. Despite this, inflation remained low, averaging 2 per cent in 2006. Investment growth surged in the second half of the year as the local interest rate cycle peaked. The residential property market divided, with prices of luxury property exceeding levels last seen in the boom in 1997 while, elsewhere in the sector, activity and prices remained flat. At the same time, investment in the construction sector was weak in the absence of large-scale infrastructure projects and general uncertainty. Externally, trade performance improved in the second half of 2006 following difficulties in the first half of the year due to volatile external demand from western markets.

Review of business performance

HSBC's operations in Hong Kong reported a pre-tax profit of US\$5,182 million compared with US\$4,517 million in 2005, an increase of 15 per cent. On an underlying basis, pre-tax profit also grew by 15 per cent. Underlying net operating income increased by 14 per cent, driven by widening deposit spreads in Personal Financial Services and Commercial Banking and strong net fee income growth in all customer groups. In Corporate, Investment Banking and Markets, an increase in trading income offset the negative impact of lower balance sheet management income. Underlying operating expenses rose by 14 per cent.

The following commentary is on an underlying basis.

Personal Financial Services pre-tax profits increased by 9 per cent to US\$2,880 million. Net operating income before impairment charges grew by 13 per cent, driven by higher income from savings and current accounts and increased fee

income. Marketing activities were successful, helping HSBC enlarge its share of the credit card and mortgage markets and attract higher deposit balances. As a result, customer numbers increased by over 100,000. The cost efficiency ratio improved by 1.1 percentage points as cost growth of 9 per cent was restricted to less than the increase in net revenue. Credit quality remained favourable and loan impairment charges were low, although higher than in 2005 when a modest recovery was recorded.

Net interest income of US\$2,882 million was 10 per cent higher than in 2005, principally as a result of deposit growth and wider liability spreads. Average savings balances increased by 7 per cent to US\$119 billion, reflecting the success of promotional campaigns and HSBC's competitive pricing strategy, and supported by increased demand for deposit products in the rising interest rate environment. Effective deposit pricing amid rising interest rates led to wider deposit spreads.

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

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

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

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Business Review

(continued)

Hong Kong > 2006

sales of unit trusts rose by 61 per cent and fee income from the sale of investment products, and custody and broking activities increased by 39 per cent.

The increase in cards in issue led to a 24 per cent rise in credit card fees. Expansion of the current account base, partly due to higher sales of packaged products, led to increased remittance and account servicing fees. HSBC focused on attracting additional funds from existing *Premier* customers during 2006 and deposits managed on their behalf increased by 29 per cent, reflecting the success of marketing campaigns and enhanced customer benefits.

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

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

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

Increased staff numbers, additional marketing activity and higher IT expenditure led to a 9 per cent rise in operating expenses. Staff recruited to support extended opening hours, together with higher performance-related remuneration and annual pay rises, led to increased employment costs. These were mitigated by a reduction in branch back-office staff numbers as customers utilised lower-cost distribution channels for an increasing proportion of their banking business. Rising Hong Kong commercial property rental yields in 2006 coincided with the expansion of certain branches with high growth potential and resulted in higher premises

costs. Marketing costs rose in support of promotional activity related to credit cards, insurance and wealth management products. Similarly, IT expenditure rose as improved portfolio management systems and enhanced channel capabilities were delivered in order to drive revenue growth.

In **Commercial Banking**, pre-tax profits increased significantly by 38 per cent to US\$1,321 million. Net operating income grew by 32 per cent, driven by higher deposit balances and fee income, increased liability spreads and lower loan impairment charges. Cost growth was comfortably within the growth in revenues, and the cost efficiency ratio improved by 1.1 percentage points to 26.1 per cent.

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

of routine transactions to automated channels.

Net interest income rose by 23 per cent to US\$1,344 million. Deposit and current account balances increased by 10 per cent, partly due to the deployment of a team dedicated to attracting deposits from small businesses, and other service enhancements. BusinessVantage, HSBC's market leading integrated account for business, reinforced its leadership position through increased promotional activity, including a new referral programme. HSBC opened over 25,000 new BusinessVantage accounts in 2006, 21 per cent more than in 2005. Interest rate rises led to a 30 basis point widening of deposit and current account spreads and contributed to increased demand for savings products.

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

[Back to Contents](#)

capitalise on cross-border financing opportunities between Hong Kong, mainland China, Taiwan and Vietnam was instrumental in contributing to the growth in mid-market lending balances.

Growth in small business lending was facilitated through a streamlined lending process and the adoption of a new credit scorecard. As a result, the number of small business customers borrowing from HSBC increased by 12 per cent and small business lending balances rose by 9 per cent. Increased competition led to a 12 basis point narrowing of asset spreads.

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

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

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

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

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

Operating expenses increased by 17 per cent to US\$491 million to support the strong revenue

opportunities evident in the market. The recruitment of additional sales and support staff and the development of the Commercial Banking insurance business contributed to higher staff numbers which, together with the effect of pay rises, resulted in higher staff costs. Marketing costs rose as HSBC stepped up its advertising and promotional activity, including the launch of the global Commercial Banking campaign to build market share. Cost efficiency was improved by the continuing migration of sales and transaction activity to lower-cost direct channels.

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

Total operating income of US\$1,849 million was 7 per cent higher. Although balance sheet management reported an overall decline, revenues recovered modestly in the second half of 2006 as lower yielding positions matured. In Global Banking, net interest income from payments and cash management activity rose sharply as a 6 per cent increase in deposits was complemented by wider spreads. Revenues benefited from improved customer flows following the launch of services offered through HSBCnet in the latter part of 2005. Income from lending activities decreased as the benefit of higher lending balances was more than offset by the effect of spread compression resulting from an abundance of credit in a highly competitive market.

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

Group Investment Businesses used HSBC's extensive distribution network to take advantage of the global trend of strong investment flows to emerging markets. Higher fees reflected strong performance fees from HSBC's emerging market funds. Client funds under management grew by 23 per cent to US\$35 billion, as HSBC launched new

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Business Review

(continued)

Hong Kong > 2006/2005

funds to capture increased demand for equity-based investments. Fees from the asset and structured finance business also rose.

Net trading income increased by 18 per cent. HSBC retained its leadership position in foreign exchange, with revenues strengthening as trading activity increased in response to volatility in the value of the US dollar and economic conditions in certain local markets. Investments in equity sales and trading operations in previous years led to higher revenues. HSBC also benefited from internal synergies linking product structuring and hedging capabilities with distribution scale, as foreign exchange option-linked deposits and other instruments were offered to retail and corporate customers.

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

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

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

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

Private Banking contributed a pre-tax profit of US\$201 million, an increase of 5 per cent compared with 2005. Growth in client assets and rising sales of higher fee-generating discretionary managed products were partially offset by the adverse effect of a flattening yield curve on income from the investment of surplus liquidity. Demand for experienced private banking staff in Hong Kong was fierce as competitors built up their locally-based operations and, despite strong revenue growth, the resultant increase in staff costs led to a 5.2 percentage points deterioration in the cost efficiency ratio to 49.5 per cent.

Net interest income was US\$76 million, in line with 2005. Steady growth in deposit balances was offset by competitive pressure on deposit rates and by a challenging interest rate environment for treasury management activities. Loans and advances to customers at 31 December 2006 were marginally

lower than at the same point in 2005 as higher interest rates reduced clients' appetite for credit.

There was excellent growth in fee income, which increased to US\$123 million, a rise of 31 per cent. Growth in funds under management and success in increasing the proportion of clients' assets invested in higher fee-earning discretionary managed assets contributed towards increased fee revenue. Fee income growth also benefited from increased client holdings of funds and alternative investments. Trading and other revenues were 18 per cent higher at US\$199 million, driven largely by sales of bonds and structured products.

Client assets increased by 27 per cent to US\$51 billion, with net new money inflows of US\$8 billion. This growth was assisted by better marketing and successful product placement, including a broadening of the discretionary managed product range. Sales of HSBC's discretionary managed SIS and CIS products, in which the

value of investments by clients reached US\$1.4 billion, continued to be a key driver of this asset class. Continued investment in relationship management, improved stock market performance and growing cross-referrals from within the Group, primarily the retail and commercial networks, also added to the growth.

Operating expenses were 31 per cent higher than in 2005, primarily due to increased staff costs driven by recruitment and the retention of front office staff in a competitive market, where demand for experienced private bankers was high. Performance-related remuneration rose, reflecting strong revenue growth and a 19 per cent increase in customer relationship staff. Increased marketing expenditure and technology costs were incurred in support of growing the business.

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

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

[Back to Contents](#)

Year ended 31 December 2005 compared with year ended 31 December 2004

Economic briefing

Hong Kong's economy grew by 7.3 per cent in 2005, down from the growth of 8.6 per cent achieved in 2004. Robust domestic demand provided strong support, particularly in the second half of the year, and external trade maintained its rapid rate of growth. Despite a substantial rise of more than 3 per cent in local interest rates in 2005, domestic demand continued to expand, reflecting a sustained improvement in business and consumer confidence. Increased consumer spending, spurred by greater job security as unemployment fell and improving household incomes, became a key driver of growth in the latter part of the year. The rise in domestic spending more than offset the slower growth in tourists' spending which occurred in 2005, particularly among mainland visitors, and consumer optimism remained unaffected by a cooling in the property market induced by the higher interest rate environment. Hong Kong's strong export performance also propelled growth, benefiting from sustained external demand and foreign importers building up inventories as trade talks continued on textile quotas between mainland China and its major trading partners. Domestic exports also picked up, reflecting increased local production. In 2005, inflation rose to 1.1 per cent, mainly driven by increased demand for property rentals.

Review of business performance

HSBC's operations in Hong Kong reported a pre-tax profit of US\$4,517 million, compared with US\$4,830 million in 2004. IFRSs changes to the treatment of preference share dividends led to a US\$387 million decrease in pre-tax profits. Excluding this, profits increased by 2 per cent. Subdued profit growth was largely attributable to a turnaround in loan impairment charges, as 2004 benefited from non-recurring releases from general provisions, and a fall in balance sheet management revenues. Pre-tax profits in Hong Kong represented around 22 per cent of HSBC's total profit at this level. In Corporate, Investment Banking and Markets, balance sheet management revenues were negatively affected by the influence of short-term interest rate rises and a flattening yield curve. Expense growth in Corporate, Investment Banking and Markets reflected the first full-year effect of the investment made to support business expansion. Pre-tax profits of Personal Financial Services and Commercial Banking grew by 27 per cent and 6 per cent respectively, benefiting from a sharp rise

in deposit spreads as short-term interest rates increased in a benign credit environment.

The commentary that follows is on an underlying basis.

Personal Financial Services reported a pre-tax profit of US\$2,628 million, 27 per cent higher than in 2004. This was largely due to widening deposit spreads, deposit growth and improved credit quality. During the year, HSBC placed considerable emphasis on maintaining its leadership position and meeting customer needs in both the credit cards and insurance businesses. Market share of both spend and balances grew in respect of credit cards along with strong insurance revenue growth.

Net interest income grew by 30 per cent to US\$2,618 million. During 2005, interest rates in Hong Kong rose significantly, reflecting rising US dollar interest rates. In addition, adjustments to the Hong Kong: US dollar linked exchange rate system reduced the likelihood of an upward realignment of the Hong Kong dollar, prompting a reversal of much of the inward flows from investors that had depressed local market rates in 2004. Consequently, deposit spreads widened to more normal levels after the exceptionally low spreads experienced in 2004. Interest rate rises also helped stimulate growth in average deposit balances as investor sentiment moved away from long-term equity-related investments into shorter-term liquid deposits. Despite the competitive deposit market, average balances grew by US\$2.9 billion, or 3 per cent.

The mortgage market remained highly competitive during 2005. During the first half of the year, HSBC did not aggressively compete on price but maintained a selective approach to mortgage approvals, mainly by offering competitive rates to the existing customer base. Yields gradually improved during the year, as HSBC repriced upwards following a series of interest rate increases. Spreads declined compared with 2004 as improvements in yields were more than offset by higher funding costs following rising interest rates. Average mortgage balances, excluding the reduction in balances under the suspended Hong Kong GHOS grew by 1 per cent, despite the highly competitive environment.


Average credit card balances grew by 10 per cent, and HSBC's market share of card balances also increased by 550 basis points led by targeted promotional campaigns and rewards programmes. These volume benefits were more than offset by lower spreads, mainly due to higher funding costs as interest rates rose.

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Business Review

(continued)


Hong Kong > 2005

Net fees fell by 6 per cent to US\$740 million, driven mainly by lower sales of unit trusts and capital guaranteed funds, partly offset by higher sales of structured deposit products and open-ended funds. A 34 per cent fall in unit trust fee income was driven by a change in market sentiment during 2005. The combined effect of higher interest rates and a flattening yield curve reduced customer demand for capital guaranteed funds and longer-term equity-related investment products. Investors preferred shorter-term investment products which in turn generated lower fees. Revenues from open-ended fund sales reflected this, increasing by 32 per cent to US\$95 million with the introduction of 173 new funds increasing the choice available to investors. This was an important strategic initiative to position HSBC as the leading investment service provider in Hong Kong, where customers can now choose from over 300 funds.

Revenues from structured deposit products grew, with strong sales volumes aided by new products launched. The success of the Exclusive Placement Service, launched in 2004 for HSBC *Premier* customers, continued with year-on-year revenue growth of 178 per cent. The service offers an extensive product range of yield enhancement options, re-priced daily and linked to foreign exchange or interest rates. IPO certificate of deposit offerings doubled. These were partly offset by lower revenues from "Deposit plus" and "Equity linked note" products.

Fee income from credit cards grew by 9 per cent, reflecting a 21 per cent increase in spending along with a 15 per cent rise in the number of cards in circulation to four million. In stockbroking and custody services, new services were launched aimed at facilitating securities management by customers. Competitive pricing and a high quality of service on the internet led to a 15 per cent growth in customers holding securities with HSBC.

HSBC continued to place significant emphasis on the growth and development of its insurance business, and increased the range of products offered. Insurance revenues grew by 20 per cent, aided by new products launched which included the "Five year excel" and the "Three year express wealth" joint life insurance and wealth products. HSBC was Hong Kong's leading online insurance provider, offering 12 insurance products. This, coupled with competitive pricing, led to a 91 per cent growth in online insurance revenues. Medical insurance products were enhanced and heavily marketed in response to the growing public demand for private medical protection to complement new medical reforms being introduced.

Improvements in credit conditions, which benefited from economic growth, higher property prices and lower bankruptcies, underpinned a net release of loan impairment charges and other credit risk provisions of US\$11 million in 2005, compared with a net charge of US\$56 million in 2004. This was mainly driven by continued improvement in credit quality within the credit card portfolio, and a collective provision release of US\$23 million in respect of prior year impairment allowances on the restructured lending portfolio. The strong housing market enabled individually assessed allowance releases of US\$24 million in the mortgage portfolio. There was also a release of US\$11 million in respect of collective loan impairment allowances, benefiting from the improved economic conditions highlighted above.

Operating expenses fell by 4 per cent to US\$1,305 million. This was largely due to a change in the method by which centrally incurred costs are allocated to the customer groups. IT development costs rose in support of future growth initiatives, and higher marketing and advertising expenditure was incurred to underpin organic growth. Staff costs were marginally lower in 2005. Branch teams were restructured to dedicate more staff to sales and customer service, and significant improvements were made to the reward structure to ensure retention of high calibre individuals. Overall, headcount in the branch network fell by 4 per cent, reflecting operating efficiency improvements and higher utilisation of the Group Service Centres.

Pre-tax profits in **Commercial Banking** increased by 6 per cent to US\$955 million. Increased deposit spreads and a rise in lending and deposit balances led to higher net interest income, though this was partly offset by larger loan impairment charges and the non-recurrence of loan allowance releases.

Net interest income increased by 60 per cent as a result of increased deposit spreads and asset and liability growth. The appointment of a number of experienced relationship managers to service key accounts, together with the establishment of core business banking centres, contributed to growth in deposits and lending. Interest rate rises led to a 67 basis point increase in deposit spreads and, together with active management of the deposit base, contributed to increased customer demand for savings products which resulted in a 6 per cent increase in deposit balances to US\$28.7 billion. The introduction of a pre-approved lending programme for SMEs, together with strong demand for credit in the property, manufacturing, trading and retail sectors, contributed to a 29 per cent increase in

[Back to Contents](#)

lending balances. However, increased competition reduced lending spreads by 43 basis points. Current account customers rose by 2 per cent to 329,000 and, together with higher spreads, contributed to an 81 per cent increase in current account net interest income. The "BusinessVantage" all-in-one account continued to perform strongly, with customers increasing by 23 per cent, which led to income more than doubling in 2005.

Net fee income increased by 10 per cent to US\$402 million as a result of efforts to encourage cross-sales, which led to an increase in average products per customer. Investment in HSBC's insurance business, including the establishment of a new Commercial Banking insurance division in October 2005, delivered a 10 per cent increase in insurance income. Enhanced product offerings and focused sales efforts in the areas of currency and interest rate management products more than doubled income. Growth in the number of merchant customers following targeted marketing campaigns, together with higher consumer spending, led to a 22 per cent increase in card income. However, these increases were partly offset by a reduced contribution from investment products, even though sales increased by 20 per cent, reflecting changes in the product mix, as demand for capital protected funds decreased in the rising interest rate environment.

Loan impairment charges and other credit risk provisions of US\$168 million contrasted with net recoveries in 2004, and included a significant charge against a client in the manufacturing sector. Releases and recoveries in 2005 were lower, although impaired loans as a proportion of lending balances decreased.

Operating expenses were 3 per cent higher, principally as a result of staff recruitment to support business development and expansion. This was particularly true with respect to business with mainland China, where additional resources were focused on increasing cross-sales and insurance income. Expenditure on new marketing campaigns promoted HSBC's lower-cost delivery channels. These campaigns, together with additional investment to increase customer access to ATMs and cheque deposit machines, grew the proportion of transactions using low cost channels to 35 per cent from 25 per cent in 2004. This released staff to concentrate on increasing sales and offering enhanced customer service.

Corporate, Investment Banking and Markets reported a pre-tax profit of US\$922 million, 43 per cent lower than in 2004, primarily driven by a

decline in net interest income in Global Markets and lower recoveries and releases of loan impairment allowances. In addition, operating expenses increased in line with initiatives taken to extend the product range in Global Markets and to strengthen the Global Investment Banking advisory platform for Asia in Hong Kong.

A 19 per cent decline in total operating income was driven by a 74 per cent fall in balance sheet management and money market revenues due to rising short-term US and Hong Kong interest rates and flattening yield curves.

In Corporate and Institutional Banking, deposit spreads increased in line with higher local interest rates, although this was offset by lending spreads which fell amidst fierce local competition. In Global Transaction Banking revenues increased, benefiting from the improvement in deposit spreads, together with higher deposit balances as business volumes grew from the upgraded cash management service delivered through HSBCnet.

Net fees fell by 19 per cent, driven primarily by a reduction in structured finance revenues. However, a number of significant equity related transactions were concluded. Fee income from Group Investment Businesses was boosted by sales of investment products and a US\$3.7 billion growth in funds under management.

Income from trading activities rose as new structured product capabilities were added in respect of credit, equities, interest rate and foreign exchange trading. Higher foreign exchange derivatives revenues reflected an increased focus on sales and execution. These gains were partly offset by a decline in sales of structured product solutions to the personal and commercial businesses, as retail investors switched to shorter deposit products in the higher interest rate environment. Losses were also incurred on the trading of Asian high-yield bonds, where revenues fell following the downgrading of the automobile sector in the first half of 2005.

The overall credit environment remained favourable and there was a small net release of loan impairment charges, although this was below levels seen in 2004 when HSBC benefited from corporate restructuring and

refinancing in the property, industrial and telecommunications sectors.

A 20 per cent rise in operating expenses was due to the first full-year impact of the investment made in Hong Kong's Corporate, Investment Banking and Markets businesses. Employee compensation and benefits rose by 24 per cent, in part driven by an increase in senior relationship managers recruited to

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Business Review

(continued)

Hong Kong > 2005 / Profit/(loss) before tax

extend coverage along industry sector lines. In total, over 90 people were recruited to support the expansion. Technology and infrastructure costs rose as support and control functions added new resources and improved services to facilitate business expansion.

Private Banking contributed a pre-tax profit of US\$190 million, an increase of 45 per cent compared with 2004. The benefits of strong growth in client assets, and consequently higher brokerage and trading income, were partly offset by the adverse effect of a flattening yield curve on income from the investment of surplus liquidity.

Net operating income was 29 per cent higher than in 2004. A 25 per cent increase in fee income reflected higher client assets, as well as the benefits of a strategy to increase the level of higher fee generating discretionary managed assets, which increased by 50 per cent during the year. Trading income increased by 39 per cent, boosted by higher volumes which reflected growth in the customer base, and a generally buoyant market. Revenue from bond trading increased by 13 per cent, and from foreign exchange and sales of structured products by 6 and 21 per cent respectively. Gains from financial investments of US\$16 million were mainly from the sale of debt instruments.

Overall, client assets increased by 17 per cent to US\$47.3 billion. Net new money inflows of US\$5.8 billion were notably strong, with recruitment of front office staff, the success of last year's launch of the "HSBC Private Bank" brand, and cross-referrals with the wider Group all contributing to the growth. Marketing, successful product placement and the enhancement of the related front office teams also aided in the increase of discretionary managed assets, with a near doubling of assets invested in the Strategic Investment Solutions product.

Operating expenses increased by 14 per cent. Costs from front office recruitment, and higher expenditure on marketing in support of the growing customer base, were partly offset by the non-recurrence of rebranding costs in 2004.

In **Other**, gains on the sale of investments and properties decreased by US\$136 million in 2005, following significant sales in 2004. These were partly offset by increased gains on the revaluation of properties of US\$70 million. Net interest income decreased as, from 1 January 2005 under IFRSs, dividends paid on certain intra-group preference shares were reclassified from non-equity minority interests to net interest income; this was partly offset by higher earnings on US dollar denominated assets following interest rate rises in the US.

[Back to Contents](#)

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

Year ended 31 December 2006

Hong Kong	Personal Financial Services US\$m	Commercial Banking US\$m	Corporate, Investment Banking & Markets US\$m	Private Banking US\$m	Other US\$m	Inter- segment elimination US\$m	Total US\$m
Net interest income/(expense)	2,882	1,344	553	76	(646)	476	4,685
Net fee income/(expense)	977	454	534	123	(32)	□	2,056
Trading income excluding net interest income	84	57	573	176	34	□	924
Net interest income on trading activities	4	□	88	□	77	(476)	(307)
Net trading income	88	57	661	176	111	(476)	617
Net income/(expense) from financial instruments designated at fair value	373	(53)	5	1	(66)	□	260
Gains less losses from financial investments	14	□	(1)	9	140	□	162
Dividend income	1	1	2	□	57	□	61
Net earned insurance premiums	2,519	95	14	□	□	□	2,628
Other operating income	202	33	81	13	781	(276)	834
Total operating income	7,056	1,931	1,849	398	345	(276)	11,303
Net insurance claims ¹	(2,638)	(50)	(11)	□	□	□	(2,699)
Net operating income before loan impairment charges and other credit risk provisions	4,418	1,881	1,838	398	345	(276)	8,604
Loan impairment (charges)/recoveries and other credit risk provisions	(119)	(69)	27	□	(11)	□	(172)

Net operating income	4,299	1,812	1,865	398	334	(276)	8,432
Total operating expenses	(1,422)	(491)	(911)	(197)	(524)	276	(3,269)
Operating profit/(loss)	2,877	1,321	954	201	(190)	□	5,163
Share of profit in associates and joint ventures	3	□	1	□	15	□	19
Profit/(loss) before tax	2,880	1,321	955	201	(175)	□	5,182

	%	%	%	%	%	%	%
Share of HSBC's profit before tax	13.0	6.0	4.3	0.9	(0.7)		23.5
Cost efficiency ratio	32.2	26.1	49.6	49.5	151.9		38.0

	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m
Selected balance sheet data²							
Loans and advances to customers (net)	35,445	23,520	20,270	3,081	1,966		84,282
Total assets	57,348	29,786	153,200	10,462	21,632		272,428
Customer accounts	118,201	41,493	24,530	11,991	476		196,691

The following assets and liabilities were significant to Corporate, Investment Banking and Markets:

□ loans and advances to banks (net)	45,023
□ trading assets, financial instruments designated at fair value, and financial investments	80,036
□ deposits by banks	4,363

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Business Review

(continued)

Hong Kong > Profit/(loss) before tax

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

Year ended 31 December 2005

Hong Kong	Personal Financial Services US\$m	Commercial Banking US\$m	Corporate, Investment Banking & Markets US\$m	Private Banking US\$m	Other US\$m	Inter- segment elimination US\$m	Total US\$m
Net interest income/(expense)	2,618	1,096	607	75	(529)	197	4,064
Net fee income	740	402	431	93	8	□	1,674
Trading income/(expense) excluding net interest income	67	48	601	140	(83)	□	773
Net interest income/(expense) on trading activities	□	□	(40)	□	10	(197)	(227)
Net trading income/(expense)	67	48	561	140	(73)	(197)	546
Net income/(expense) from financial instruments designated at fair value	41	(84)	14	□	23	□	(6)
Gains less losses from financial investments	□	□	□	16	92	□	108
Dividend income	1	2	18	□	20	□	41
Net earned insurance premiums	2,238	77	19	□	□	□	2,334
Other operating income	230	35	83	13	682	(238)	805
Total operating income	5,935	1,576	1,733	337	223	(238)	9,566
Net insurance claims ¹	(2,016)	(34)	(9)	□	□	□	(2,059)
Net operating income before loan impairment charges and other credit risk	3,919	1,542	1,724	337	223	(238)	7,507

provisions							
Loan impairment (charges)/ recoveries and other credit risk provisions	11	(168)	7	3	1	□	(146)
Net operating income	3,930	1,374	1,731	340	224	(238)	7,361
Total operating expenses	(1,305)	(419)	(809)	(150)	(422)	238	(2,867)
Operating profit/(loss)	2,625	955	922	190	(198)	□	4,494
Share of profit in associates and joint ventures	3	□	□	□	20	□	23
Profit/(loss) before tax	2,628	955	922	190	(178)	□	4,517
	%	%	%	%	%		%
Share of HSBC's profit before tax	12.5	4.6	4.4	0.9	(0.9)		21.5
Cost efficiency ratio	33.3	27.2	46.9	44.5	189.0		38.2
	US\$m	US\$m	US\$m	US\$m	US\$m		US\$m
Selected balance sheet data ²							
Loans and advances to customers (net)	34,318	20,292	23,712	3,107	1,779		83,208
Total assets	52,798	25,625	133,005	7,621	16,327		235,376
Customer accounts	105,801	37,417	21,070	9,216	222		173,726
The following assets and liabilities were significant to Corporate, Investment Banking and Markets:							
□ loans and advances to banks (net)			39,164				
□ trading assets, financial instruments designated at fair value, and financial investments			63,813				
□ deposits by banks			4,373				

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[Back to Contents](#)

Year ended 31 December 2004

Hong Kong	Personal Financial Services US\$m	Commercial Banking US\$m	Corporate, Investment Banking & Markets US\$m	Private Banking US\$m	Other US\$m	Inter- segment elimination US\$m	Total US\$m
Net interest income/(expense)	2,015	684	998	85	(144)	□	3,638
Net fee income/(expense)	786	365	529	75	(52)	□	1,703
Trading income/(expense)	47	39	476	101	(4)	□	659
Net investment income on assets backing policyholders □ liabilities	118	196	□	□	□	□	314
Gains less losses from financial investments	(2)	□	2	□	175	□	175
Dividend income	2	1	2	□	22	□	27
Net earned insurance premiums	1,620	609	19	□	(1)	□	2,247
Other operating income	294	52	101	(2)	561	(470)	536
Total operating income	4,880	1,946	2,127	259	557	(470)	9,299
Net insurance claims ¹	(1,400)	(742)	(12)	□	□	□	(2,154)
Net operating income before loan impairment charges and other credit risk provisions	3,480	1,204	2,115	259	557	(470)	7,145
Loan impairment (charges)/ recoveries and other credit risk provisions	(56)	110	164	4	(2)	□	220
Net operating income	3,424	1,314	2,279	263	555	(470)	7,365
Total operating expenses	(1,364)	(406)	(674)	(132)	(452)	470	(2,558)
Operating profit	2,060	908	1,605	131	103	□	4,807
Share of profit/(loss) in associates and joint ventures	3	(4)	(2)	□	26	□	23
Profit before tax	2,063	904	1,603	131	129	□	4,830
	%	%	%	%	%		%
Share of HSBC's profit before tax	10.9	4.7	8.5	0.7	0.7		25.5
Cost efficiency ratio	39.2	33.7	31.9	51.0	81.1		35.8
Selected balance sheet data ²	US\$m	US\$m	US\$m	US\$m	US\$m		US\$m

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Loans and advances to customers (net)	33,646	17,883	22,440	2,954	1,901	78,824
Total assets	49,620	23,272	129,986	7,490	14,968	225,336
Customer accounts	114,302	35,226	18,903	9,264	338	178,033

The following assets and liabilities were significant to Corporate, Investment Banking and Markets:

□ loans and advances to banks (net)	42,515
□ trading assets, financial instruments designated at fair value, and financial investments	59,703
□ deposits by banks	4,205

- 1 *Net insurance claims incurred and movement in policyholders' liabilities.*
- 2 *Third party only.*

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Business Review

(continued)

*Rest of Asia-Pacific > 2006***Rest of Asia-Pacific (including the Middle East)**

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

	Year ended 31 December		
	2006 US\$m	2005 US\$m	2004 US\$m
Personal Financial Services	477	377	336
Commercial Banking	1,034	818	483
Corporate, Investment Banking and Markets	1,649	1,207	942
Private Banking	80	78	60
Other	287	94	26
	3,527	2,574	1,847

	Year ended 31 December		
	2006 US\$m	2005 US\$m	2004 US\$m
Australia and New Zealand	182	111	84
Brunei	36	35	33
India	393	212	178
Indonesia	71	113	76
Japan	123	(1)	50
Mainland China	708	334	32
Malaysia	274	236	214
Middle East (excluding Saudi Arabia)	730	585	364
Saudi Arabia	305	236	122
Middle East	1,035	821	486
Philippines	58	41	38
Singapore	365	289	272
South Korea	59	94	89
Taiwan	(23)	68	107
Thailand	49	61	60
Other	197	160	128
	3,527	2,574	1,847

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

Economic briefing

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

Export growth remained strong, accelerating slightly during the second half of 2006 despite evidence of slower global growth. Although a

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

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

[Back to Contents](#)

Profit before tax

	Year ended 31 December		
	2006 US\$m	2005 US\$m	2004 US\$m
Rest of Asia-Pacific (including the Middle East)			
Net interest income	3,047	2,412	2,060
Net fee income	1,622	1,340	1,041
Trading income	1,181	860	494
Net income from financial instruments designated at fair value	79	58	□
Net investment income on assets backing policyholders' liabilities	□	□	32
Gains less losses from financial investments	41	18	17
Dividend income	5	5	3
Net earned insurance premiums	174	155	97
Other operating income	765	335	146
Total operating income	6,914	5,183	3,890
Net insurance claims incurred and movement in policyholders' liabilities	(192)	(166)	(82)
Net operating income before loan impairment charges and other credit risk provisions	6,722	5,017	3,808
Loan impairment charges and other credit risk provisions	(512)	(134)	(89)
Net operating income	6,210	4,883	3,719
Total operating expenses	(3,548)	(2,762)	(2,087)
Operating profit	2,662	2,121	1,632
Share of profit in associates and joint ventures	865	453	215
Profit before tax	3,527	2,574	1,847
	%	%	%
Share of HSBC's profit before tax	16.0	12.3	9.8
Cost efficiency ratio	52.8	55.1	54.8
Year-end staff numbers (full-time equivalent)	72,265	55,577	41,031
	US\$m	US\$m	US\$m
Selected balance sheet data¹			
Loans and advances to customers (net)	77,574	70,016	60,663
Loans and advances to banks (net)	27,517	19,559	14,887
Trading assets, financial instruments designated at fair value, and financial investments	41,585	30,348	31,065
Total assets	167,668	142,014	120,530
Deposits by banks	10,323	7,439	8,046
Customer accounts	108,995	89,118	78,613

¹ Third party only.

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

Private investment, from both domestic and foreign sources, was also high while abundant liquidity, rising employment and rapid population growth supported further increases in private consumption. Although interest rates rose, tracking those in the US over the course of the year, credit growth continued to be strong. Robust

domestic demand and the weakness of the US dollar boosted inflationary pressures. Following corrections in the first half of 2006, the major regional stock exchange indices continued to trade at significant discounts to the record levels registered in late 2005, with markets remaining generally sluggish.

Elsewhere in the region, most economies continued to perform impressively, particularly India, Singapore and Vietnam. The main drivers of growth were exports, demand for technology, and domestic consumption, with investment demand lagging behind. India was among the strongest performing economies in the world, with GDP growth of about 9 per cent in 2006. This led to some signs of overheating, with inflation rising during the year. The

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Business Review

(continued)

Rest of Asia-Pacific > 2006

Reserve Bank of India responded by raising interest rates, and there may be more increases to come. GDP in Singapore grew by 8 per cent in 2006, in Vietnam by over 7 per cent and in Malaysia by approximately 6 per cent, their economies benefiting from generally low inflation and strong domestic and external demand. Most Asian currencies ended 2006 stronger than the US dollar. A US slowdown is a risk for the region.

Review of business performance

HSBC's operations in the Rest of Asia-Pacific delivered a pre-tax profit of US\$3,527 million compared with US\$2,574 million in 2005, an increase of 37 per cent. On an underlying basis, pre-tax profits grew by 29 per cent, with the major change in composition of the Group being the additional 10 per cent stake purchased in Ping An Insurance in August 2005 which made that company a 19.9 per cent owned associate of HSBC.

Pre-tax profits in the region have nearly doubled in the past two years, justifying HSBC's strategy of investing in emerging markets. Momentum in 2006 was strong, with underlying net operating income increasing by 26 per cent, notwithstanding a significant rise in loan impairment charges arising primarily from industry-wide credit deterioration in the credit card portfolio in Taiwan, mainly in the first half of 2006. Significant increases in total operating income and pre-tax profits were reported in the Middle East, India, Singapore and Malaysia. In Taiwan, HSBC launched the direct savings proposition which had been received very positively in the US. HSBC's strategic investments in mainland China, Bank of Communications and Industrial Bank, contributed to a 54 per cent underlying increase in income from associates.

The commentary that follows is on an underlying basis.

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

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

Net interest income increased by 24 per cent to US\$1,520 million. Average asset and liability balances grew strongly, while interest rate rises contributed to a 31 basis point widening of deposit spreads. Asset spreads were in line with 2005.

Average deposit balances rose by 16 per cent to US\$34.4 billion, principally due to growth in the HSBC *Premier* customer base. Development of the *Premier* business was supported by a concerted customer acquisition campaign which included regional and local advertising and the establishment of new, dedicated *Premier* centres. Overall deposit balance growth was especially strong in Singapore, the Middle East and mainland China. In

Singapore, promotional campaigns, which included a deposit product sale, contributed to a 23 per cent increase in liability balances while, in the Middle East, HSBC ran a deposit raising campaign with new product launches, marketing and internal sales incentives, leading to a 20 per cent rise in average deposit balances. In mainland China, growth in HSBC *Premier*, which accompanied the opening of 12 new *Premier* sub-branches, contributed to higher deposit balances.

Average loans and advances to customers rose by 16 per cent, driven by higher credit card advances and increased mortgage balances. Average card balances increased by 22 per cent to US\$3.1 billion, reflecting higher cardholder spending and a 21 per cent increase in cards in circulation. Over 2.5 million cards were issued during 2006, with new products launched in the Middle East, Sri Lanka and Singapore. HSBC ran marketing and incentive campaigns in a number of countries and card balances rose substantially in Malaysia, the Middle East, Indonesia, India and the Philippines.

Average mortgage balances increased by 13 per cent to US\$18.9 billion, reflecting robust growth in Singapore, Taiwan, India and Malaysia. In Singapore, HSBC used targeted promotional rates to build market share and this, together with increased marketing activity, contributed to a 25 per cent increase in mortgage balances. In Taiwan,

[Back to Contents](#)

competitive pricing and customer retention initiatives contributed to a rise in customer numbers and resulted in a 22 per cent increase in average mortgage balances. In India, mortgage balances rose by 27 per cent, benefiting from increased marketing and direct sales efforts, while in Malaysia, the successful promotion of Homeshmart, a flexible offset mortgage product, enabled HSBC to increase average mortgage balances by 10 per cent and widen spreads in a highly competitive market.

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

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

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

HSBC continued to develop its regional insurance business by launching medical insurance in Singapore and establishing a Takaful joint venture in

Malaysia, offering Shariah-compliant insurance products. In the Middle East, cardholder credit insurance was launched in the fourth quarter of 2006. These product launches were supported by increased marketing activity and targeted investment to increase HSBC's presence and market share. Consequently, the number of policies in force at the end of 2006 rose by 89 per cent to 800,000 and insurance fee income and insurance premiums rose by 12 per cent and 4 per cent respectively.

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

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

Operating expenses increased by 26 per cent to US\$1,593 million, largely tracking revenue growth. Expansion of the branch network and development of sales and support functions led to higher staff numbers and, together with higher performance-related incentive payments, contributed to a rise in staff costs. The new branch

openings increased premises and equipment costs. The establishment of a number of consumer finance businesses and HSBC Direct's introduction in Taiwan were also factors in the rise in operating expenses.

Marketing costs rose as HSBC increased advertising and promotional activity directed to attracting new customers, enlarging HSBC's share of the credit card, mortgage and unsecured personal lending markets and increasing deposit balances. In

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Business Review

(continued)

Rest of Asia-Pacific > 2006

the Middle East, IT expenditure rose as HSBC introduced a new internet banking infrastructure, implemented HSBC's WHIRL credit card system and made major updates to customer relationship management software.

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

Commercial Banking reported a pre-tax profit of US\$1,034 million, 25 per cent higher than in 2005. Pre-provision operating income increased by 25 per cent, driven by higher deposit and lending balances and widening liability spreads. The migration of routine activities to lower-cost channels helped to mitigate business expansion costs, and operating expenses consequently increased by 21 per cent. The cost efficiency ratio improved by 1.4 percentage points.

During 2006, HSBC focused on developing its cross-border business banking activities and increasing its presence in the small business market, supported by investment in delivery channels and increased promotional activity. International business banking benefited from the strong performance of HSBC's two regional alignment programmes, centred on mainland China and the Middle East, together with the establishment of International Business Centres in seven sites including Australia, mainland China, India and Taiwan. In addition, new branches in mainland China, India, Malaysia, Bangladesh and Sri Lanka were complemented by enhancements to internet banking services in Malaysia and India and improved self-service terminals in a number of countries. The launch of HSBC's inaugural global Commercial Banking advertising campaign, increased local marketing activity and the reorganisation of business development teams throughout the Asia-Pacific region contributed to an 8 per cent increase in Commercial Banking customer numbers to 177,000, with particularly strong growth in Malaysia, mainland China and India.

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

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

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

in average lending balances.

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

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

The transfer of the majority of HSBC's Asian card acquiring business into a joint venture with

[Back to Contents](#)

Global Payments Inc. led to the recognition of a gain of US\$10 million in Commercial Banking, reported in □Other operating income□.

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

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

Income from HSBC□s strategic investments in associates increased by 47 per cent. Income from Bank of Communications rose by 45 per cent as a result of higher asset and liability balances, effective credit control and improvements in the cost efficiency ratio, while income from Industrial Bank was 55 per cent higher. In the Middle East, net releases of loan impairments, following net charges in 2005, led to strong growth in Commercial Banking income in The Saudi British Bank.

Corporate, Investment Banking and Markets delivered a record pre-tax profit of US\$1,649 million, an increase of 35 per cent compared with 2005. Positive revenue trends were reported across most countries, reflecting continued growth in HSBC□s wholesale banking businesses in emerging markets. The Middle East, India, Taiwan and Singapore accounted for 66 per cent of the increase in pre-tax profits. The cost efficiency ratio improved by 3.5 percentage points to 37.6 per cent.

Total operating income increased by 29 per cent compared with 2005 to US\$2,311 million. In Global Markets, the securities services business benefited from investment flows into and within emerging markets, leading to higher customer volumes in buoyant local markets.

In Global Banking, payments and cash management services increased in all countries, with significant contributions from businesses in India, the

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

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

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

Group Investment Businesses revenues more than doubled, reflecting higher funds under management and performance fees on emerging market funds.

Net trading income of US\$717 million rose by 26 per cent, benefiting from an increasing interest rate environment and volatile foreign exchange markets. Although, generally, volatility levels were lower than those

experienced in 2005, the emerging market correction in May 2006 combined with a rapid recovery in the second half of the year to stimulate a rise in foreign exchange and Credit and Rates volumes in most countries. HSBC also benefited from higher foreign investment flows as investor confidence in the improved stability of emerging economies grew. In the second half of 2006, growth in revenues from retail structured investment products moderated as investors sought outright exposure to equities and deposit yields improved. However, in the Middle East, there was strong demand for structured interest rate products among corporate and institutional customers and for risk management advisory products as clients continued to hedge exposures.

Gains on the disposal of financial investments were higher than in 2005, largely due to income from the sale of debt securities in the Philippines in 2006,

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Business Review

(continued)

Rest of Asia-Pacific > 2006 / 2005

together with the non-recurrence of losses on the disposal of US dollar securities in Japan in January 2005.

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

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

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

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

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

Net interest income grew by 21 per cent to US\$35 million. Growth was predominantly in Singapore, where treasury performance improved and unfavourable positions unwound, and India, where the recently launched business was successful in attracting deposits.

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

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

Client assets increased by 12 per cent to US\$16 billion, benefiting from the recruitment of front office staff, client appetite for investment in newly launched funds and the successful growth of recently launched onshore businesses in the region. Investment in funds benefited from higher demand for HSBC and third party manager funds, including the SIS and CIS products in which the value of client investments grew to US\$291 million. Higher deposits and investments in equities also contributed to the growth in client assets.

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

recruitment in 2005 fed through.

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

Year ended 31 December 2005 compared with year ended 31 December 2004

Economic briefing

Mainland China's economy grew by 9.9 per cent in 2005. Despite ongoing monetary tightening, total urban fixed asset investment growth showed no sign of slowing, though investment in steel and real estate sectors moderated. Consumer spending also remained strong, with retail sales growing by 13 per cent in 2005. Producer price inflation slowed, but still remained above 3 per cent thanks to strong investment demand. In July 2005, the People's Bank of China announced that, with immediate effect, the arrangement by which the renminbi (RMB) was pegged to the US dollar would be replaced with a managed float. Initially, the exchange rate was set at US\$1 to RMB8.11, equivalent to an appreciation of approximately 2 per cent. This had little impact on export growth, which remained very strong, boosting mainland China's annual trade surplus from US\$32 billion in 2004 to US\$102 billion in 2005. Growth in food prices slowed as mainland China's grain production increased 3 per cent in 2005. This lowered consumer price inflation to 1.8 per cent from 3.9 per cent at the end of 2004.

[Back to Contents](#)

Japan's economy in 2005 achieved its strongest growth in five years, and the long process of structural readjustment following the collapse in asset prices was largely completed. In particular, the excess corporate capacity, employment and debt of the past decade was eliminated, and impaired bank loans returned to historically normal levels. After a downturn which began in mid-2004, exports began to recover vigorously in March 2005, led by strong demand from mainland China. The decline in corporate borrowing ceased, and the end of net corporate debt reduction freed up cash which drove stronger growth in private capital investment. The tightening of the labour market boosted employment and led to a sustained rise in real wages for the first time in five years, providing strong support for consumer spending. The rise in the core consumer price index in November 2005 set the stage for the end of the Bank of Japan's quantitative easing policy.

Elsewhere in the region, most economies performed impressively in 2005, in particular India's. The main drivers of growth were exports, demand for technology, and domestic consumption. Investment demand, by contrast, remained weak. Strong domestic growth and continued firmness in energy prices resulted in an increase in inflationary pressures, especially in Indonesia and Thailand, where fuel subsidies were lowered or removed. Central banks in both these countries increased rates substantially. Elsewhere, particularly in South Korea and Taiwan, energy prices did not significantly affect headline inflation, and the benign inflationary environment was maintained with less need for monetary tightening. Most Asian currencies ended the year strongly against the US dollar.

2005 was a good year economically for the **Middle East**, where growth was boosted by high oil prices and additional capacity in downstream oil and gas, real estate, transportation and tourism. Long-term growth was reinforced through economic liberalisation. The result was to encourage private sector investment in both established and new sectors of the region's economy. Regional interest rates mirrored US dollar rate increases during the year without any noticeable effect on credit growth, though inflationary pressures arose from the US dollar's weakness and general economic expansion. GDP growth is estimated by the International Monetary Fund to have been over 6 per cent in Saudi Arabia in 2005. Economies in the region which are not as dependent on oil also performed well, with the United Arab Emirates, for example, registering strong growth in non-oil sectors such as financial services and tourism.

Review of business performance

HSBC's operations in the Rest of Asia-Pacific reported a pre-tax profit of US\$2,574 million, compared with US\$1,847 million in 2004, representing an increase of 39 per cent. On an underlying basis, pre-tax profits grew by 29 per cent and represented around 12 per cent of HSBC's equivalent total profit. Strong growth across the majority of countries in the region resulted in higher revenues across all customer groups.

The commentary that follows is on an underlying basis.

Personal Financial Services reported a pre-tax profit of US\$377 million, an increase of 6 per cent compared with 2004, reflecting higher net interest income led by strong asset and deposit growth, increased fee income and higher income from investments in the Middle East and mainland China. Costs in support of business expansion rose and were broadly in line with revenue growth. Higher loan impairment charges reflected growth in credit card lending and the non-recurrence in 2005 of loan impairment provision releases in 2004.

Net interest income grew by 25 per cent to US\$1,208 million, reflecting strong growth across the majority of countries in the region. Deposit balances generally grew strongly during 2005. This was due in part to the range of new products launched during the year, including dual currency, floating rate and higher-yielding time deposits. The number of *Premier* account holders rose significantly, with a 40 per cent growth across the region generating US\$3.5 billion of additional balances. In mainland China, organic expansion continued, with the opening of ten new branches and sub-branches. The deposit base grew by 80 per cent, as considerable emphasis was placed on the provision of wealth management services through the HSBC *Premier* account service. Deposit spreads also widened as interest rates rose, contributing to higher net interest income in mainland China, Singapore and India.

In the Middle East, a rise of 37 per cent in net interest income was driven by a combination of widening deposit spreads and strong loan growth, partly offset by lower asset spreads as funding costs increased following

interest rate rises. Average mortgage balances increased by 27 per cent to US\$16.7 billion. This growth reflected marketing campaigns in India, Malaysia and Singapore alongside new products introduced in Australia and South Korea. Higher sales volumes were also generated by direct sales forces across the region, notably in India, where mortgage balances grew by

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Business Review

(continued)

Rest of Asia-Pacific > 2005

43 per cent. The benefits of higher mortgage balances were partly offset by lower spreads as pricing stayed highly competitive.

The credit card business continued to expand in a number of countries. Credit card spending increased by 33 per cent, contributing to a 42 per cent growth in average card balances. Other notable developments included promotional campaigns, new product launches and a series of customer acquisition strategies including the exclusive rewards programme, *Home and Away*. At the end of the year, the number of cards in circulation stood at 6.3 million, representing an increase of 34 per cent over 2004. In India, the number of cards in circulation exceeded one million for the first time. Higher card balances led to higher net interest income in Indonesia, India, Taiwan, Malaysia and the Philippines.

Net fee income grew by 46 per cent to US\$419 million, largely attributable to strong sales of investment and insurance products, and increased account service fees. Credit card fee incomes rose, driven by the strong growth in cardholder spending. Commissions from sales of unit trusts and funds under management were particularly strong in Singapore, India and Taiwan. Sales of investment products, comprising unit trusts, bonds and structured notes, grew by 43 per cent to US\$6.5 billion, generating a 56 per cent increase in fee income. The launch of over 217 tranches of structured notes and deposit products in 11 countries across the region achieved total sales of US\$952 million. Total funds under management rose by 33 per cent or US\$7.2 billion, led by increased marketing activity and the considerable focus placed on wealth management services during the year. HSBC Bank Malaysia maintained its position as the leading international institutional unit trust agent in the country. Brokerage and custody fees grew, particularly in Australia, where a 13 per cent rise reflected increased stock market activity.

HSBC continued to emphasise the expansion of its insurance business across the region. The number of policies in force increased by 27 per cent and revenues grew by 16 per cent.

Loan impairment charges and other credit risk provisions doubled compared with 2004. This was due to the non-recurrence of a release of a general provision in Malaysia in 2004, and a sharp rise in credit card provisions in Taiwan, reflecting deteriorating credit conditions. Growth in personal unsecured lending and credit cards across the region contributed further to the increased charge.

Operating expenses increased by 29 per cent to US\$1,245 million in support of business growth. HSBC spent considerable amounts in the region enhancing its existing infrastructure in order to benefit fully from the opportunities presented by the Asian growth economies. Staff costs of US\$469 million rose by 23 per cent, as employee numbers increased to support business growth and to increase sales and wealth management activities. Performance-related remuneration costs were also higher as a result of the strong growth in profitability.

Marketing costs rose as major campaigns were run to support product promotions in mortgages, credit cards, insurance and investment products. Continued emphasis was placed on brand awareness in order to generate additional business and reinforce HSBC's position as the world's local bank across the region, and this further increased costs. Various growth initiatives required investment in technology, and the development of new distribution channels resulted in higher IT costs. Other expenses, including professional fees and communications costs, rose in support of business expansion.

Increased contributions from HSBC's investments in Bank of Communications and Industrial Bank in mainland China, together with record earnings from The Saudi British Bank, contributed to strong growth in profit from

associates.

Commercial Banking reported a pre-tax profit of US\$818 million, 45 per cent higher than that delivered in 2004. The increase was mainly due to higher net interest income as growth in customer numbers and strong credit demand to fund infrastructure investment drove balance sheet growth. Higher contributions from Bank of Communications and Industrial Bank in mainland China, as well as a strong performance in The Saudi British Bank, produced higher income from associates. Lending balances increased by 16 per cent, exceeded by a 24 per cent rise in deposits.

Net interest income increased by 33 per cent to US\$631 million, reflecting growth in the Middle East, Singapore, mainland China, Indonesia and Taiwan. In the Middle East, strong regional economies and significant government-backed infrastructure and property projects, principally in the United Arab Emirates, contributed to a 37 per cent growth in lending balances and a 42 per cent increase in customer account balances. Higher trade flows generated a 25 per cent increase in net interest income from trade services, while higher interest rates raised liability spreads by 118 basis points. A new Amanah term investment product was launched

[Back to Contents](#)

in May 2005, attracting US\$120 million of deposits, principally from new customers seeking Shariah-compliant investment opportunities.

In mainland China, strong economic growth, expansion of the branch network and the recruitment of additional sales staff resulted in a 39 per cent increase in lending balances. Deposit balances also benefited from economic growth, increasing by 38 per cent, while deposit spreads widened by 76 basis points following increases in US interest rates.

In Singapore, interest rate rises prompted increased demand for savings products and consequently deposit balances grew by 13 per cent, while deposit spreads increased by 13 basis points. Lending balances rose by 27 per cent, following the selective recruitment of more experienced relationship managers and a reorganisation of customers into key industrial sectors to provide greater focus on identifying service opportunities. Asset spreads decreased by 42 basis points as a result of competitive pressures and market liquidity.

In Taiwan, a loyalty campaign designed to increase deposits, together with higher current account income and an increase in deposit spreads, contributed to an 80 per cent increase in net interest income. In Mauritius, net interest income doubled as a result of liability balance growth. In India, increased trade contributed to higher trade services net interest income and strong economic growth stimulated demand for credit. This resulted in lending balances increasing by 72 per cent, while customer acquisition increased average current account balances by 37 per cent. Liability spreads widened by 73 basis points following interest rate rises. In Indonesia, increased sales efforts and a more focused approach to customer relationship management contributed to an 84 per cent growth in asset balances and a 66 per cent increase in net interest income.

Net fee income of US\$307 million was 15 per cent higher than in 2004. In the Middle East, increased trade flows led to a 17 per cent increase in trade services income, while current account income increased by 80 per cent, benefiting from the introduction of new cash management capabilities. Short-term IPO loan funding reflecting, in part, the robustness of the regional capital market, also contributed to a 40 per cent increase in net fee income. In mainland China, a 31 per cent increase in trade customers and a significant rise in imports led to higher trade services income, while a 49 per cent increase in current account customers and higher lending fees also contributed to an 8 per cent increase in fee income. Increased lending, current account and

trade activities raised net fee income by 30 per cent in Indonesia. A number of sites, including Vietnam and Thailand, also reported strong growth, driven by the success of HSBC's strategy of focusing on business opportunities involving international trade.

There was a net release of loan impairment charges of US\$67 million, following net charges in 2004. Credit quality in the Middle East improved. In mainland China there was a significant reduction in loan impairment charges as higher collective impairment charges were more than offset by the release of allowances against a small number of accounts and the non-recurrence of a significant charge against a single customer in 2004. In India, strong economic growth led to improved credit quality, while in Malaysia, Singapore and Indonesia, credit quality improved significantly although releases of impairment charges were lower than in 2004.

Operating expenses were 27 per cent higher than last year, broadly in line with revenue growth. In the Middle East, the recruitment of sales and support staff substantially increased income, leading to higher incentive payments. In mainland China, revenue growth was driven by branch expansion, increased sales and support staff and higher marketing expenditure. In Malaysia, the direct sales teams were expanded and business banking units were extended to all branches in support of the bank's growth strategy, resulting in a 16 per cent increase in costs.

In India, the recruitment of additional sales staff boosted customer facing staff by 85 per cent in 2005. In South Korea, staff recruitment and heightened marketing activity supported HSBC's four recently established commercial banking centres, contributing to an increase in costs. Higher costs throughout the rest of the region largely reflected increases in sales and support staff and initiatives to support business expansion.

Increased income from associates reflected strong performance in The Saudi British Bank and gains on the sale of HSBC's indirect stake in MISR International, an Egyptian Bank. Income from the bank's strategic

investments in mainland China, Bank of Communications and Industrial Bank, which were acquired in 2004, also increased.

Corporate, Investment Banking and Markets reported a pre-tax profit of US\$1,207 million, an increase of 22 per cent compared with 2004. HSBC's progress in this region was marked by positive revenue trends across most countries, with strong growth being reported in the Middle East, Malaysia, South Korea, India and mainland China.

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Business Review

(continued)

Rest of Asia-Pacific > 2005

Operating income rose by 25 per cent to US\$1,769 million. Higher Corporate and Institutional Banking revenues reflected a 53 per cent increase in lending balances in mainland China, a result of strong demand for corporate credit, primarily from the industrial and technology sector. Deposit balances increased by 36 per cent and this, together with a 40 basis point rise in deposit spreads, also contributed to the growth in revenues.

HSBC's operations in the Middle East reported a 63 per cent rise in customer advances, primarily due to strong demand for corporate credit, driven by government spending on regional infrastructure projects.

Global Transaction Banking revenues increased, as payments and cash management benefited from an increase in regional mandates which added to average balances, together with a widening of deposit spreads, notably in Singapore, India and Thailand.

In Global Markets, balance sheet management and money market revenues fell, particularly in Singapore and Japan, due to the effect of rising short-term interest rates and a flattening of the yield curves.

Net fee income increased by 17 per cent. In Global Transaction Banking, the expansion in business capabilities which took place in the latter part of 2004 drove an increase in volumes, with marked improvements in Singapore, South Korea and India. Revenues from the custody business increased against the backdrop of rising local stock market indices as investor sentiment in the region improved. Additionally, securities services in India generated higher business volumes, with assets under custody growing by US\$9 billion to US\$34 billion. In Singapore, fee income increased by 55 per cent, reflecting an increase in revenues from securities services activities as HSBC leveraged its relationship strength and product capabilities to attract new business.

In the Middle East, corporate lending and trade finance activity generated higher customer volumes as regional economies strengthened from an increase in foreign investment, tourism and higher real estate and oil prices. Global Investment Banking benefited from the resulting demand for cross-border business, with an increase in fees from advisory and project and export finance services.

Income from trading activities increased, in part due to higher revenues from foreign exchange and structured derivatives, which were driven by enhanced distribution and expanded product capabilities. In South Korea, volatility in the Korean

won against the US dollar encouraged strong customer flows in foreign exchange. In Malaysia, a rise in customer demand, following the move to a managed float for the Malaysian ringgit, improved trading volumes in foreign exchange. Global Markets in Taiwan generated higher revenues, due to improved sales of structured derivative products. Falling interest rates in the Philippines resulted in favourable price movements on government bond portfolios. In the Middle East, HSBC's enhanced capability in structured transactions and greater focus on trading in the regional currencies drove volumes higher in a volatile market.

Gains from the disposal of the Group's asset management business in Australia added US\$8 million to other operating income.

Net recoveries on loan impairment charges were marginally lower than in 2004.

Reflecting higher performance-related incentives, operating expenses increased by 21 per cent to US\$733 million, broadly in line with the growth in operating income. 2005 bore the first full-year effect of the recruitment in 2004 of over 600 additional staff, of which more than half were in Global Transaction Banking. The upgrade of corporate and support teams across the region within Corporate and Institutional Banking resulted in some 280 additional people. The cost base was further affected by investment in HSBCnet and other technology costs incurred to support business expansion.

Income from associates included increased contributions from HSBC's investments in Bank of Communications and Industrial Bank, which were acquired in 2004.

Private Banking reported a pre-tax profit of US\$78 million, an increase of 32 per cent compared with 2004. Investment in the business over the past two years was reflected in strong growth in client assets and net new money inflows of US\$2.3 billion, against a backdrop of intense competition in the region. Net operating income increased by 17 per cent, predominantly due to higher trading income.

Net interest income fell by 29 per cent to US\$30 million compared with 2004. Balance sheet growth was mainly in Singapore and Japan, where client deposits increased by 44 and 64 per cent respectively. Lending to customers also grew strongly, with the loan book increasing by some 26 per cent. The net interest income benefits of these were more than offset by lower treasury margins earned in the rising interest rate environment, and the reclassification under IFRSs from 1 January 2005 of

[Back to Contents](#)

net interest income on certain derivatives to [net trading income].

Trading income increased by 62 per cent. Strong growth in bond trading and sales of structured products, which increased by 28 and 20 per cent respectively, was compounded by the reclassification from net interest income mentioned above. Fee income was broadly in line with 2004, with the benefit of growth in client assets largely offset by the non-recurrence of exceptionally high brokerage volumes driven by the market recovery last year.

Client assets increased by 23 per cent to US\$13.7 billion. Front office recruitment and marketing campaigns, and inflows from the operations launched in Dubai in 2005 and Malaysia in 2004, boosted asset growth in the region. Net new money of US\$2.3 billion was 22 per cent higher than last year, with inflows strongest in Singapore and Japan.

Operating expenses increased by only 6 per cent, leading to a 5 percentage point improvement in the cost efficiency ratio. Front office recruitment in most countries contributed to a small increase in staff costs, and expenditure on marketing and administrative expenses rose to support business growth.

In **Other**, the Group's Service Centres continued to expand to support HSBC's productivity improvements, incurring US\$129 million of incremental costs, offset by higher recharges to other customer groups. Higher interest rates led to increased earnings on centrally held investments. In Thailand, the sale of a residential property led to a gain of US\$11 million and in India, litigation provisions raised in 2004 were not repeated.

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Business Review

(continued)

Rest of Asia-Pacific > Profit before Tax

Profit before tax by customer groups and global businesses

Year ended 31 December 2006

Rest of Asia-Pacific (including the Middle East)	Personal Financial Services	Commercial Banking	Corporate, Investment Banking & Markets	Private Banking	Other	Inter-segment elimination	Total
	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m
Net interest income	1,520	848	802	35	61	(219)	3,047
Net fee income	524	330	688	68	12	□	1,622
Trading income/(expense) excluding net interest income	61	86	717	74	(3)	□	935
Net interest income on trading activities	□	□	□	□	27	219	246
Net trading income	61	86	717	74	24	219	1,181
Net income from financial instruments designated at fair value	59	4	4	□	12	□	79
Gains less losses from financial investments	2	2	38	(1)	□	□	41
Dividend income	□	□	1	□	4	□	5
Net earned insurance premiums	148	26	□	□	□	□	174

Other operating income	<u>108</u>	<u>20</u>	<u>61</u>	<u>□</u>	<u>667</u>	<u>(91)</u>	<u>765</u>
Total operating income	2,422	1,316	2,311	176	780	(91)	6,914
Net insurance claims ¹	<u>(180)</u>	<u>(11)</u>	<u>□</u>	<u>□</u>	<u>(1)</u>	<u>□</u>	<u>(192)</u>
Net operating income before loan impairment charges and other credit risk provisions	2,242	1,305	2,311	176	779	(91)	6,722
Loan impairment (charges)/recoveries and other credit risk provisions	<u>(545)</u>	<u>29</u>	<u>5</u>	<u>□</u>	<u>(1)</u>	<u>□</u>	<u>(512)</u>
Net operating income	1,697	1,334	2,316	176	778	(91)	6,210
Total operating expenses	<u>(1,593)</u>	<u>(554)</u>	<u>(869)</u>	<u>(96)</u>	<u>(527)</u>	<u>91</u>	<u>(3,548)</u>
Operating profit	104	780	1,447	80	251	□	2,662
Share of profit in associates and joint ventures	<u>373</u>	<u>254</u>	<u>202</u>	<u>□</u>	<u>36</u>	<u>□</u>	<u>865</u>
Profit before tax	477	1,034	1,649	80	287	□	3,527
	%	%	%	%	%		%
Share of HSBC's profit before tax	2.2	4.7	7.5	0.4	1.2		16.0
Cost efficiency ratio	71.1	42.5	37.6	54.5	67.7		52.8
Selected balance	US\$m	US\$m	US\$m	US\$m	US\$m		US\$m

sheet data²

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

The following assets and liabilities were significant to Corporate, Investment Banking and Markets:

loans and advances to banks (net)	22,171
trading assets, financial instruments designated at fair value, and financial investments	36,580
deposits by banks	9,849

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[Back to Contents](#)

Year ended 31 December 2005

	Personal Financial Services	Commercial Banking	Corporate, Investment Banking & Markets	Private Banking	Other	Inter- segment elimination	Total
Rest of Asia-Pacific (including the Middle East)	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m
Net interest income	1,208	631	614	30	54	(125)	2,412
Net fee income	419	307	498	43	73	□	1,340
Trading income/(expense) excluding net interest income	37	70	579	74	(7)	□	753
Net interest income/(expense) on trading activities	1	(1)	(21)	□	3	125	107
Net trading income/(expense)	38	69	558	74	(4)	125	860
Net income from financial instruments designated at fair value	44	1	4	□	9	□	58
Gains less losses from financial investments	□	4	12	2	□	□	18
Dividend income	□	□	1	□	4	□	5
Net earned insurance premiums	134	21	□	□	□	□	155
Other operating income	37	9	82	4	287	(84)	335
Total operating income	1,880	1,042	1,769	153	423	(84)	5,183
Net insurance claims ¹	(157)	(9)	□	□	□	□	(166)
Net operating income before loan impairment charges and other credit risk provisions	1,723	1,033	1,769	153	423	(84)	5,017
Loan impairment (charges)/ recoveries and other credit risk provisions	(236)	67	35	2	(2)	□	(134)
Net operating income	1,487	1,100	1,804	155	421	(84)	4,883

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Total operating expenses	(1,245)	(452)	(733)	(77)	(339)	84	(2,762)
Operating profit	242	648	1,071	78	82	□	2,121
Share of profit in associates and joint ventures	135	170	136	□	12	□	453
Profit before tax	377	818	1,207	78	94	□	2,574

	%	%	%	%	%		%
Share of HSBC's profit before tax	1.8	3.9	5.8	0.4	0.4		12.3
Cost efficiency ratio	72.3	43.8	41.4	50.3	80.1		55.1

	US\$m	US\$m	US\$m	US\$m	US\$m		US\$m
Selected balance sheet data ²							
Loans and advances to customers (net)	27,433	18,694	21,431	2,347	111		70,016
Total assets	32,224	22,570	76,026	5,359	5,835		142,014
Customer accounts	31,250	18,612	32,102	7,092	62		89,118

The following assets and liabilities were significant to Corporate, Investment Banking and Markets:

loans and advances to							
□ banks (net)			15,352				
□ trading assets, financial instruments designated at fair value, and financial investments			26,113				
deposits by							
□ banks			7,041				

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Business Review

(continued)

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

Profit before tax by customer groups and global businesses (continued)

Year ended 31 December 2004

	Personal Financial Services	Commercial Banking	Corporate, Investment Banking & Markets	Private Banking	Other	Inter- segment elimination	Total
Rest of Asia-Pacific (including the Middle East)	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m
Net interest income	948	472	596	42	2	□	2,060
Net fee income	284	266	421	41	29	□	1,041
Trading income	43	59	344	46	2	□	494
Net investment income on assets backing policyholders' liabilities	32	□	□	□	□	□	32
Gains less losses from financial investments	1	□	6	□	10	□	17
Dividend income	□	□	□	□	3	□	3
Net earned insurance premiums	77	20	□	□	□	□	97
Other operating income	28	13	26	2	157	(80)	146
Total operating income	1,413	830	1,393	131	203	(80)	3,890
Net insurance claims ¹	(72)	(10)	□	□	□	□	(82)
Net operating income before loan impairment charges and other credit risk provisions	1,341	820	1,393	131	203	(80)	3,808
Loan impairment (charges)/ recoveries and other credit risk provisions	(117)	(20)	47	1	□	□	(89)
Net operating income	1,224	800	1,440	132	203	(80)	3,719
Total operating expenses	(949)	(350)	(598)	(72)	(198)	80	(2,087)
Operating profit	275	450	842	60	5	□	1,632
Share of profit in associates and joint ventures	61	33	100	□	21	□	215
Profit before tax	336	483	942	60	26	□	1,847

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	%	%	%	%	%	%
Share of HSBC's profit before tax	1.8	2.6	5.0	0.3	0.1	9.8
Cost efficiency ratio	70.8	42.7	43.0	55.0	97.5	54.8
	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m
Selected balance sheet data ²						
Loans and advances to customers (net)	22,886	16,444	19,276	1,960	97	60,663
Total assets	25,577	18,845	66,438	4,549	5,121	120,530
Customer accounts	28,961	15,381	28,620	5,543	108	78,613
The following assets and liabilities were significant to Corporate, Investment Banking and Markets:						
loans and advances						
□ to banks (net)			12,119			
trading assets, financial instruments designated at fair value, and financial investments			26,555			
□ deposits by banks			7,156			

1 Net insurance claims incurred and movement in policyholders' liabilities.

2 Third party only.

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

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

	Year ended 31 December		
	2006 US\$m	2005 ¹ US\$m	2004 ¹ US\$m
Personal Financial Services	3,391	4,181	3,826
United States	3,128	3,853	3,642
Canada	253	310	157
Bermuda	10	18	27
Commercial Banking	957	892	691
United States	442	447	417
Canada	437	403	239
Bermuda	78	42	35
Corporate, Investment Banking and Markets	423	573	879
United States	199	373	741
Canada	189	154	134
Bermuda	31	43	4
Other	4	3	□
Private Banking	114	104	68
United States	107	104	65
Bermuda	7	□	3
Other	(217)	165	(196)
United States	(264)	158	(201)
Canada	17	(12)	□
Bermuda	29	19	5
Other	1	□	□
Total	4,668	5,915	5,268
United States	3,612	4,935	4,664
Canada	896	855	530
Bermuda	155	122	74
Other	5	3	□

¹ In 2006, Mexico and Panama were reclassified from the North America segment to the Latin America segment. Comparative information has been restated accordingly.

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

Economic briefing

In the **US**, GDP growth in 2006 was 3.4 per cent. Growth in the second half of the year moderated to below 3 per cent, after average annualised growth of 4.1 per cent in the first half of the year. Consumer spending in 2006 grew by 3.4 per cent, with average annualised growth of 3.6 per cent in the second half of the year. Housing activity weakened substantially in 2006, with annualised declines in residential investment of 11 per cent in the second quarter followed by annualised declines of 19 per cent in the third and fourth quarters of the year. There was some optimism that housing starts may have begun to stabilise by the year-end, with housing permits rising in December after ten successive monthly falls. Continued strong profits growth meant that business investment remained robust but industrial production weakened markedly towards the end of the year. The unemployment rate remained relatively low, averaging 4.6 per cent in 2006. The trade deficit

stabilised through most of the year and narrowed in the final months of 2006 in response to strong global growth and a weaker US dollar. Inflation rose by 4.3 per cent in the first half of the year due to energy price rises but subsequently fell to an annual rate of about 2 per cent as energy prices declined. The Federal Reserve raised short-term interest rates by 1 per cent in the first half of 2006 to 5.25 per cent, but kept rates unchanged thereafter. After rising from 4.4 per cent to 5.2 per cent in the first half of 2006, 10-year note yields fell to a low of 4.4 per cent in early December before increasing to 4.7 per cent by the year-end. The S&P500 stock market index rose by 13.6 per cent in the year.

The **Canadian** economy slowed during 2006, with GDP growth falling from an annualised rate of 3.6 per cent at the beginning of the year to 1.7 per cent by the third quarter, largely reflecting slower export growth. Domestic demand remained robust and HSBC expects the momentum seen in 2006 to continue through 2007, supported by historically low levels of unemployment and a housing market

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Business Review

(continued)

North America > 2006

Profit before tax

	Year ended 31 December		
	2006 US\$m	2005 ¹ US\$m	2004 ¹ US\$m
North America			
Net interest income	14,268	13,295	13,787
Net fee income	4,766	3,952	3,197
Trading income	1,358	885	509
Net income/(expense) from financial instruments designated at fair value	(63)	434	□
Net investment income from assets backing policyholders' liabilities	□	□	□
Gains less losses from financial investments	58	47	147
Dividend income	85	41	32
Net earned insurance premiums	492	477	450
Other operating income	922	642	341
Total operating income	21,886	19,773	18,463
Net insurance claims incurred and movement in policyholders' liabilities	(259)	(232)	(236)
Net operating income before loan impairment charges and other credit risk provisions	21,627	19,541	18,227
Loan impairment charges and other credit risk provisions	(6,796)	(4,916)	(5,036)
Net operating income	14,831	14,625	13,191
Total operating expenses	(10,193)	(8,758)	(7,915)
Operating profit	4,638	5,867	5,276
Share of profit/(loss) in associates and joint ventures	30	48	(8)
Profit before tax	4,668	5,915	5,268
	%	%	%
Share of HSBC's profit before tax	21.1	28.2	27.8
Cost efficiency ratio	47.1	44.8	43.4
Year-end staff numbers (full-time equivalent)	55,642	53,608	49,416
	US\$m	US\$m	US\$m
Selected balance sheet data²			
Loans and advances to customers (net)	277,987	252,560	240,151
Loans and advances to banks (net)	17,865	10,331	20,911
Trading assets, financial instruments designated at fair value, and financial investments ³	145,700	112,225	49,196
Total assets	511,190	432,490	348,132
Deposits by banks	11,484	7,780	13,720
Customer accounts	120,922	111,386	117,551

- 1 *In 2006, Mexico and Panama were reclassified from the North America segment to the Latin America segment. Information disclosed in respect of 2005 and 2004 has been restated accordingly.*
- 2 *Third party only.*
- 3 *Including financial assets which may be repledged or resold by counterparties.*

which, although showing signs of moderation, remained strong throughout 2006. Although energy prices eased, 2006's commodity boom was expected to continue benefiting the Canadian economy through 2007. Inflation remained problematic with core prices moving above the Bank of Canada's (BoC) preferred target rate of 2 per cent, and productivity remained relatively weak. Having raised its overnight interest rate from 3.25 per cent at the start of 2006 to 4.25 per cent in May, the BoC kept rates on hold for the rest of the year.

Review of business performance

HSBC's operations in North America reported a pre-tax profit of US\$4,668 million compared with US\$5,915 million in 2005, a decrease of 21 per cent. On an underlying basis, pre-tax profits declined by 25 per cent. Underlying net operating income before loan impairment charges was higher by 6 per cent, reflecting the income benefit of asset growth in Personal Financial Services. This revenue growth was more than offset by a significant rise in loan impairment charges in the correspondent mortgage services business within HSBC Finance, as slowing house price appreciation and the projected effect of

[Back to Contents](#)

interest rate resets impacted loss estimates from rising credit delinquency. This is described more fully below and on page 189. In Commercial Banking, investment in distribution channels delivered growth from increased lending and deposit taking. In Corporate, Investment Banking and Markets, strong trading results more than offset lower balance sheet management revenues, which were constrained by compressed spreads in a flat interest rate yield curve environment. Underlying operating expenses increased by 13 per cent to support investment in business expansion and branch openings in the Personal Financial Services business.

The commentary that follows is on an underlying basis.

Personal Financial Services generated a pre-tax profit of US\$3,391 million, a decrease of 23 per cent compared with 2005. Net operating income rose at a slower rate than cost growth, due to constrained balance sheet growth in the second half of the year, higher collection expense and significantly higher loan impairment charges. The increased loan impairment charges recognised in respect of HSBC Finance's correspondent mortgage services business more than offset the non-recurrence of charges arising in respect of hurricane Katrina and the change in bankruptcy legislation in 2005. The cost efficiency ratio worsened as costs rose faster than revenues.

In the US, pre-tax profit of US\$3,128 million was 24 per cent lower than in 2005, reflecting the significantly higher loan impairment charges noted above and additional costs incurred in support of business expansion in both the consumer finance company and the retail bank. Beginning in 2004, HSBC implemented a growth strategy for its core banking network in the US which included building deposits over a three to five year period across multiple markets and segments utilising diverse delivery systems. During 2006 the strategy included various initiatives, the most important of these being growing the deposit base by emphasising more competitive pricing and introducing high yielding products, including internet savings accounts. These have grown significantly since late 2005 to US\$7 billion, of which US\$6 billion arose in 2006 and US\$5 billion of the 2006 growth was from new customers. Retail branch expansion in existing and new geographic markets was also a key initiative, with 25 new branches opened in 2006.

In Canada, profit before tax was 21 per cent lower, partly due to the absence of provision releases made in 2005 in the core banking operations. Revenues rose but this was offset by costs incurred

in support of expansion in consumer finance and investments made in the bank distribution channels.

Net interest income of US\$12,964 million was 7 per cent higher than in 2005. In the US, there was strong growth in mortgages, cards and other personal non-credit card lending, particularly in the first half of the year, and this, coupled with higher deposit balances, led to a 6 per cent increase in net interest income as competition reduced both asset and deposit spreads.

Average deposit balances in the US rose by 21 per cent to US\$32.2 billion, mainly led by the continued success of online savings. The HSBC *Premier* investor product also continued to grow strongly. During the year over 22,000 new accounts were opened and balances rose by 139 per cent as US\$2.1 billion in incremental deposits were taken. Customers migrated to higher yielding products which led to a change in product mix, and the consequent reduction in spreads partly offset the benefits of balance growth.

There was a marked slowdown in the US housing market during 2006, although towards the end of the year demand for housing showed signs of stabilising. However, the supply of houses for sale remained high, with the overall outlook still uncertain. Average mortgage balances rose by 9 per cent to US\$123.8 billion, with growth concentrated in non-prime balances in the mortgage services correspondent and branch-based consumer lending businesses. Prime mortgage balances originated and retained through the core banking network continued to decline. This reflected an ongoing strategic initiative to manage the balance sheet by selling the majority of new prime loan originations to government-sponsored enterprises and private investors, along with planned securitisations and the normal run-off of balances. Overall, yields improved from the combined effects of a change in product mix to higher-yielding non-prime mortgages and repricing initiatives. Despite this improvement in yields, spreads narrowed due to higher funding costs as interest rates rose, and this reduced the positive income benefit of the higher lending balances.

The following comments on mortgage lending relate to HSBC Finance as mortgage lending growth in 2006 was concentrated in this business.

In the branch-based consumer lending business, average mortgage balances grew by 15 per cent to US\$41.2 billion as lending secured on real estate, which included a near-prime product introduced in 2003, was pursued. This growth was augmented by portfolio acquisitions, most notably the

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Business Review

(continued)

North America > 2006

US\$2.5 billion Champion mortgage portfolio purchased from KeyBank, NA in November 2006.

In the mortgage services correspondent business, average balances of US\$49.9 billion were 28 per cent higher than in 2005. During 2005 and the first half of 2006, emphasis was placed on increasing both first and second lien mortgages by expanding sources for the purchase of loans from correspondents. In the second quarter of 2006, HSBC began to witness deterioration in the performance of mortgages acquired in 2005, particularly in the second lien and portions of the first lien portfolios. This deterioration continued in the third quarter and began to affect the equivalent loans acquired in 2006. In the final quarter of 2006, the deterioration worsened considerably, mainly in first lien adjustable rate mortgage (ARM) balances and second lien loans.

A series of actions were initiated in the third quarter to mitigate risk in the affected components of the portfolio. These included revising pricing in selected origination segments, tightening underwriting criteria to eliminate or substantially reduce higher risk products (especially in respect of second lien, stated income (low documentation) and lower credit scoring segments), and enhancing segmentation and analytics to identify higher risk portions of the portfolio and increase collections. These initiatives led to a decline in overall portfolio balances during the second half of 2006, mostly attributable to lower purchases of second lien and certain higher-risk products, along with the normal run-off of balances.

Average credit card balances in the US rose by 6 per cent to US\$26.8 billion. The market continued to be highly competitive with many lenders placing reliance on promotional rate offers to generate growth. HSBC took a strategic decision to reduce the amount of its equivalent offers and instead grew its HSBC branded prime, Union Privilege and non-prime portfolios largely from targeted marketing campaigns. Margins widened, reflecting improved yields as the product mix changed towards higher levels of non-prime and lower levels of promotional balances, coupled with other re-pricing initiatives undertaken on variable rate products. This more than offset the adverse effect of higher funding costs and augmented the income benefits of the increased loan book.

In the retail services business, average balances rose by 6 per cent to US\$15.8 billion. This was mainly driven by newer merchants, changes in product mix and the launch of three co-branded programmes; the MasterCard and Visa partnerships

with Best Buy and Saks Fifth Avenue, and the Neiman Marcus co-branded card with American Express. The positive income benefits from higher balances were more than offset by lower spreads, as a large proportion of the loan book priced at fixed rates was affected by higher funding costs. This was further affected by changes in the product mix as lower yielding department store card balances grew more strongly, and by competitive downward pricing pressures. Changes in merchant contractual obligations also led to lower net interest income, though this was offset by reduced partnership payments to those merchants.

Growth opportunities in the motor vehicle financing industry were particularly challenging in 2006, driven by a reduction in incentive programmes offered by manufacturers and a rising interest rate environment. Notwithstanding these factors, average balances rose by 12 per cent. This was led by strong organic growth in the near-prime portfolio from an increased emphasis on strengthening relationships with active dealers, and greater volumes generated from the consumer direct programme. Refinancing volumes rose, directly attributable to the successful consumer refinance programme, which recorded a 48 per cent increase in originations.

In Canada, net interest income rose by 16 per cent due to lending and deposit growth. Average mortgage balances grew as a result of the continued strength of the housing market and ongoing branch expansion in the

consumer finance business. The strong economy drove higher levels of unsecured lending as consumer spending rose. Expansion of the consumer finance motor vehicle proposition and the launch of a MasterCard programme in 2005 contributed further to asset growth, while increased marketing activity led to a rise in personal non-credit card lending balances. Asset spreads narrowed, largely from lower yields which reflected changes in product mix and competitive market conditions.

Average deposit balances grew by 6 per cent compared with 2005, with the notable success of a new high rate savings account and a sale campaign celebrating HSBC's 25th anniversary in Canada. Deposit spreads widened as interest rates rose, contributing further to the increase in net interest income.

Net fee income grew by 13 per cent to US\$3,675 million, with increases in both the US and Canada. The 13 per cent rise in the US was largely led by higher fees from the credit card and retail services businesses. Credit card fee income from the consumer finance business increased by 8 per cent, primarily from balance growth in the non-prime

[Back to Contents](#)

portfolio, improved interchange rates and lower fee charge-offs. Revenues from credit card partnership enhancement services rose due to greater sales volumes, expansion into new customer segments and balance growth.

Within the US retail services business, net fee income rose, reflecting lower merchant payments, in part due to changes in contract obligations with certain merchants. A rise in late fees from growth in customer account balances and higher fees on overdue payments contributed further to the increase.

In the US mortgage-banking business, net fee income declined. Although mortgage loan service volumes grew in 2006, contributing additional fee income from the greater proportion of mortgages originated and then sold with mortgage servicing rights retained, these benefits were more than offset by higher amortisation charges and lower releases of temporary impairment provisions on mortgage servicing rights. The taxpayer financial services business generated higher fee income from increased loan volumes during the 2006 tax season.

In Canada, net fee income rose by 5 per cent to US\$217 million. Continued growth in the wealth management business resulted in higher investment administration fees, and credit card fee income rose, driven by increased lending.

Trading income fell by 17 per cent, due to lower income on HSBC Finance's Decision One mortgage balances held for resale to secondary market purchasers. This primarily reflected additional losses incurred following the repurchase of certain mortgages previously sold to external third parties which had subsequently gone into default. Higher losses on derivatives that did not meet the criteria for hedge accounting contributed further to the decrease.

A US\$20 million gain from the MasterCard Incorporated IPO was the key reason for the increase in gains from financial instruments.

Other operating income also rose, primarily driven by gains on various asset disposals. Most notably, a US\$123 million profit was achieved on disposal of HSBC's investment in Kanbay International Inc, a worldwide information technology services firm. Income from overnight and short-term money market investments also rose. These benefits were partly offset by greater losses incurred on sales of repossessed properties, following a 42 per cent rise in such properties as customers defaulted on their mortgage payments.

Loan impairment charges and other credit risk provisions of US\$6,683 million were 28 per cent

higher than in 2005. In the US, loan impairment charges rose by 28 per cent despite the non-recurrence of significant charges which arose in 2005 following hurricane Katrina and increased levels of bankruptcy filings in the final quarter of the year. Loan impairment charges were also higher in the second half of 2006 compared with both the preceding half and the second half of 2005. The increase was primarily driven by significantly higher delinquencies and losses in the mortgage services correspondent business, concentrated in second lien and portions of first lien mortgages originated and purchased in 2005 and 2006. As noted previously, HSBC witnessed a deterioration in the performance of these 2005 originations during the first half of 2006. This deterioration continued into the third quarter and started to affect equivalent loans originated in 2006. In the final quarter of 2006, deterioration of these loans, largely the first lien adjustable rate and second lien loans, worsened considerably. The heightened risk of loss was attributable to lower equity in homes as price growth moderated or reversed, together with a higher prospective interest burden from ARM resets. As many of these mortgages were being re-priced in an environment of higher interest rates, slower asset price appreciation and tightening credit, HSBC considers it highly likely that these factors will lead to increased instances of default in the future on both first and any associated second lien loans. Accordingly, a significant increase in loan impairment charges was recorded in the final quarter of the year.

Higher lending, the seasoning¹ of the loan portfolio, and a return to more normal historical levels of delinquency from the exceptionally favourable credit conditions experienced in recent periods, all contributed to the overall increase in impairment charges in the US. This was partly offset by lower numbers and levels of bankruptcy filings and the positive effect of low unemployment. The credit card business, in addition, benefited from improved recovery rates from loans previously written off. Notwithstanding the accelerated credit weakness

witnessed in the mortgage services correspondent business, credit performance as measured by delinquency and loss in the majority of the other lending portfolios, including mortgage balances originated through the branch-based consumer lending business gradually deteriorated from the seasoning of a growing portfolio and the rising proportion of credit card balances. Loan impairment charges in these portfolios were

¹ *[Seasoning] describes the emergence of credit loss patterns in portfolios over time.*

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Business Review

(continued)

North America > 2006

consequently higher in the second half of 2006 as these portfolios seasoned, coinciding with the weakening housing market.

In Canada, loan impairment charges were 38 per cent higher. This primarily reflected the non-recurrence of loan impairment releases from core banking operations, which occurred in 2005, as well as growth in both secured and unsecured lending balances and higher delinquency rates in the motor vehicle finance business.

Operating expenses grew by 12 per cent to US\$7,379 million. In the US, costs of US\$6,706 million were 11 per cent higher than in 2005. In the consumer finance business, the rise was driven by increased headcount to support incremental collections activity, and greater volumes. Higher costs were incurred in marketing cards to support the launch of new co-branded credit cards, greater levels of mailing and other promotional campaigns in the cards and retail services businesses. IT and administrative expenses grew in support of higher asset balances. A lower level of deferred origination costs in the mortgage services business, due to a decline in volumes, contributed further to the cost growth.

In HSBC Bank USA, expense growth was primarily driven by branch staff costs from additional headcount recruited to support investment in business expansion and new branch openings. Greater emphasis placed on increasing the quality and number of branch staff dedicated to sales and customer relationship activities, which changed the staff mix, also contributed to cost growth. The continued promotion of the on-line savings product, new branch openings and branding initiatives at the John F. Kennedy International and LaGuardia airports in New York led to a rise in marketing costs. IT costs also grew following significant investment expenditure incurred on several key network efficiency projects.

In Canada, costs rose by 19 per cent, mainly due to higher staff and marketing costs. Staff costs grew by 13 per cent, with increased headcount supporting expansion of the consumer finance business and bank distribution network. Continuing investment in growing the wealth management business and higher incentive costs reflecting improved revenues also contributed to the increase. Marketing costs grew following external campaigns to improve brand awareness.

Commercial Banking's pre-tax profits rose by 4 per cent to US\$957 million, largely driven by lending and deposit growth and higher fee income, partly offset by increased loan impairment charges.

Costs rose mainly from geographical expansion in the US and branch and business expansion in Canada. The cost efficiency ratio worsened by 2.1 percentage points, as costs grew faster than revenues.

Net interest income grew by 15 per cent to US\$1,362 million. In the US, net interest income was 13 per cent higher, as HSBC continued to expand its geographical presence, notably in Boston, Connecticut, New Jersey, Philadelphia, Washington D.C., Chicago and Los Angeles. Average deposit balances rose by 30 per cent, aided by geographical expansion and greater focus placed on generating balances from commercial real estate companies and middle market customers. In particular, there was an increased emphasis on attracting high margin balances from cash management sales activities. Rising interest rates encouraged customers to transfer funds to higher yielding products and the resulting change in product mix led to a narrowing of liability spreads.

The 7 per cent growth in average lending balances was principally led by greater volumes generated from small business and middle market customers. This was achieved by a combination of geographical expansion, increased marketing activity and the recruitment of additional small-business relationship managers. Asset

spreads narrowed due to competitive pricing pressures, particularly in the middle market customer segment, which partly offset the income benefits from higher lending volumes.

In Canada, net interest income increased by 14 per cent. The strong economy encouraged continued business investment by customers and this, in conjunction with HSBC's reputation for customer service and relationship management, helped generate a 15 per cent growth in average lending balances. Loan spreads were broadly in line with 2005. There was a 35 per cent improvement in average deposit balances, driven by various factors including the acquisition of new customers, strengthening relationships with existing ones, and enhancing payment and cash management products. Deposit spreads widened as interest rates rose, augmenting the income benefits from higher balances.

Net interest income in Bermuda grew by 42 per cent, partly due to interest rate rises which widened deposit spreads. Deposit balances increased by 26 per cent, while increased cross-sales activity contributed to a 26 per cent rise in average lending balances.

[Back to Contents](#)

Net fee income improved by 13 per cent to US\$329 million. In the US, the 11 per cent rise was primarily due to an increase in syndication capabilities, which led to higher commercial mortgage fees, and from business expansion into new geographical markets. In Canada, growth in new lending business led to higher levels of service charges, and credit fees increased following the rise in customer numbers. Product enhancements and additions to the sales force helped grow fee income from payment and cash management services.

There was a small reduction in other operating income, largely due to the net effects of lower gains on asset disposals in the US.

Also in the US, the redemption of bonds issued by the Venezuelan government led to a US\$19 million gain from financial instruments.

Loan impairment charges were US\$74 million compared with a net release of US\$21 million in 2005. In the US, the increase reflected strong growth in lending balances to small and middle market customers, higher write-offs in the small business segment and the exceptionally low charges recorded in 2005 compared with historical levels. Loan impairment charges rose in Canada following the non-recurrence of releases which occurred in 2005 and, in Bermuda, net releases compared with charges in 2005.

Operating expenses grew by 21 per cent to US\$814 million. The 27 per cent rise in the US was driven by a combination of increased costs incurred in support of geographical expansion and the recruitment of additional sales staff to drive revenue growth. In Canada, operating expenses were 14 per cent higher from additional headcount recruited to support branch and network expansion and increased salary and bonus costs, which reflected improved revenues. Expenditure incurred in order to develop the business, largely due to HSBC brand campaigns, contributed further to cost growth.

Income from associates rose by US\$34 million, including HSBC's share from an equity investment in Wells Fargo HSBC Trade Bank N.A. of US\$11 million in the US. Income from associates of US\$22 million in Canada was attributable to higher gains and distributions from private equity fund investments. These funds, in which HSBC has maintained a minority interest, were established to provide institutional investors with access to private equity investment opportunities.

Corporate, Investment Banking and Markets reported a pre-tax profit of US\$423 million, 28 per cent lower than in 2005. The result in 2005 benefited

from a US\$106 million favourable movement on ineffective hedges on HSBC's own debt and, excluding this, profit before tax decreased by 12 per cent. The fall in profits was primarily due to a decline in balance sheet management revenues. Balance sheet management activity continued to be constrained by compressed spreads in a flat interest rate yield curve environment, with a resultant decrease of US\$347 million. Operating expenses were higher by 19 per cent with a significant portion of the increase driven by the first full year effect of recruitment and business expansion in 2005, and by specific initiatives taken in early 2006. This investment in extending the trading platform, notably in mortgage-backed securities, structured derivatives, metals and foreign exchange, produced record trading revenues.

Net fee income and trading income also grew, reflecting the measures taken to strengthen HSBC's presence in the region.

In Global Banking, net interest income in payments and cash management rose by 66 per cent, largely due to an over 50 per cent growth in balances.

Net fee income rose by 13 per cent to US\$656 million. Increases in fee income within the newly expanded mortgage-backed securities and equity underwriting businesses were driven by higher volumes. The securities services business benefited from a combination of new client volumes and market-driven asset growth. However, income from debt underwriting activity declined due to fewer deals, particularly in the second half of the year. In Global Banking, higher transaction volumes in the recently enhanced payments and cash management business, and an increase in customer volumes driven by a wider product offering, led to higher net fee income.

HSBC's operation in Canada reported a 31 per cent increase in fees, reflecting a growth in funds under management within Group Investment Businesses, coupled with higher fees from the lending business and HSBC Securities Services.

Net trading income more than doubled to US\$818 million. In Global Markets, a wider product offering and improved sales capabilities drove significant gains across all major client-related activities. Revenues were further boosted by the first full year contribution from the mortgage-backed securities trading business. Credit and Rates benefited from tightening credit spreads and increased customer flows. Structured derivatives income more than doubled, reflecting successful product launches as well as increased sales of

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Business Review

(continued)

North America >2006 / 2005

tailored solutions. Revenues in the foreign exchange business remained robust against the backdrop of a weakening US dollar.

In Canada, trading income more than doubled, with higher gains from foreign exchange; a result of increased volatility of the Canadian dollar against the US dollar.

Gains from financial investments were 79 per cent lower as income from the disposal of securities declined.

A 50 per cent increase in other income was driven in part by higher revenues in HSBC's Sharia-compliant property fund business, which were offset by higher related costs.

The overall credit environment remained stable, although a small loan impairment charge of US\$3 million compared unfavourably to a net release of US\$64 million in 2005.

Operating expenses increased by 19 per cent to US\$1,641 million, mainly due to the first full year effect of the business expansion which took place in 2005 and additional expenditure in early 2006. In Global Markets, cost growth was primarily driven by the mortgage-backed securities, structured derivatives and equity businesses. Staff costs increased by 11 per cent, reflecting the first full year effect of people recruited in 2005, performance incentives that rose in line with revenue and selective hires in early 2006.

Operational expenses in the payments and cash management and the securities services businesses increased as business volumes grew and the related support businesses were expanded.

HSBC's share of profits from associates declined significantly reflecting the non-recurrence of distributions from a private equity associate.

Private Banking contributed a pre-tax profit of US\$114 million, an increase of 12 per cent compared with 2005. HSBC's onshore presence was enhanced by the opening of offices in Chicago and Greenwich, Connecticut. Revenue growth, driven by significantly higher core fees and commissions and improved trading results, was offset in part by loan impairment charges of US\$35 million, US\$29 million of which related to a single customer. The cost efficiency ratio improved by 6.2 percentage points to 70.4 per cent.

Net interest income increased by 15 per cent to US\$212 million. A deposit-raising campaign proved successful at garnering funds, the total raised by the year-end reaching US\$2.5 billion. Overall, deposit balances rose by 25 per cent and lending balances

increased by 14 per cent. Deposit spreads were marginally lower than in 2005.

Net fee income grew strongly, increasing by 20 per cent to US\$240 million. Wealth and Tax Advisory Services (WTAS) continued to expand its client base – it rose by 31 per cent in 2006 – and reported significant revenue growth, benefiting from restrictions placed on the major auditing firms with regard to providing personal tax advice to employees of audit clients. Higher funds under management and an increase in referrals with other HSBC businesses also contributed to the increased level of fee income.

A one-off gain of US\$9 million arose from a partial disposal of a holding in the Hermitage Fund, offsetting the non-recurrence of US\$9 million of income following the sale of a number of small trust businesses in 2005.

Client assets increased by 5 per cent to US\$43 billion, with net new money of US\$5 billion. This included a significant contribution from the higher fee-earning discretionary SIS and CIS products in which the value of client assets rose to US\$1.4 billion.

Operating expenses of US\$355 million were 10 per cent higher than in 2005. This rise was primarily attributable to hiring front office private banking staff and fee-earning staff within WTAS.

In **Other**, movements in the fair value of own debt and associated swaps resulted in losses of US\$128 million in 2006, compared with profits of US\$401 million in 2005.

Business expansion led to higher transaction volumes, which resulted in increased utilisation of IT systems and solutions. Branch expansion, the integration of Metris, and the launch of new products also contributed to an 8 per cent increase in costs and income at the group's North American technology centre. In hsbc.com, accrued costs associated with the development of HSBC's second generation internet banking platforms were recharged to other customer groups, which resulted in higher operating income.

Year ended 31 December 2005 compared with year ended 31 December 2004

Economic briefing

Despite cooling in the fourth quarter, GDP growth in the **US** was 3.5 per cent in 2005. Consumer spending grew by a healthy 3.6 per cent in 2005 despite slowing in the fourth quarter because of the hurricanes, higher energy costs and lower auto sales. Growth in equipment and software investment was

[Back to Contents](#)

robust, rising 11 per cent. Unemployment fell by 0.5 per cent to 4.9 per cent in 2005, with 2 million new jobs created. The Federal Reserve's favoured inflation measure, the core personal consumption expenditure deflator, was contained, rising 2 per cent in 2005. Headline inflation in 2005 was higher due to increased energy prices, as the full year consumer price index rose 3.4 per cent. The Federal Reserve raised interest rates eight times during the year, from 2.25 per cent to 4.25 per cent. 10-year bond yields and equity markets rose moderately during 2005 as the US dollar strengthened, ending the year at US\$1.18 to the euro compared with US\$1.35 at the end of 2004.

Canada's growth was 2.9 per cent in 2005, as strong employment growth and, late in the year, rising earnings, boosted consumer spending. The unemployment rate fell to 6.4 per cent, the lowest level since 1976. In the second half of the year, exports rose, boosted by strong global demand. In the energy sector, investment and profits rose strongly as oil prices soared, with the positive economic impact being most pronounced in Western Canada. Gasoline prices lifted headline inflation to a peak of 3.4 per cent in September, but it fell back sharply and core inflation was 1.6 per cent by the year-end. Having been kept on hold for much of the year, interest rates were raised by 75 basis points between September and December. The BoC has indicated that further increases may be required.

Review of business performance

HSBC's operations in North America reported a pre-tax profit of US\$5,915 million, compared with US\$5,268 million in 2004, representing an increase of 12 per cent. On an underlying basis, pre-tax profits grew by 11 per cent and represented around 28 per cent of HSBC's equivalent total profit. In the US, the benefits from strong deposit growth in Personal Financial Services were partly negated by narrowing spreads on lending in the rising interest rate environment. In Commercial Banking, growth in pre-tax profits was largely driven by lending and deposit balance growth and improved liability interest margins. In Corporate, Investment Banking and Markets, growth in revenues was offset by investment expenditure to build the platform and infrastructure required for future growth.

The commentary that follows is on an underlying basis.

Personal Financial Services, including the consumer finance business, generated a pre-tax profit of US\$4,181 million, 9 per cent higher than in 2004. Under IFRSs, from 1 January 2005, HSBC

changed the accounting treatment for certain debt issued and related interest rate swaps. This did not change the underlying economics of the transactions. The resulting revenues of US\$618 million in 2004 are excluded from the following commentary. In addition, interest income earned on mortgage balances held on HSBC's balance sheet pending sale into the US secondary mortgage market was reported under trading income. In 2004 this was reported in net interest income. This difference in treatment is also excluded from the following commentary.

In the US, profit before tax rose 28 per cent to US\$3,853 million. The rise in profit was largely driven by widening deposit spreads, strong deposit and customer loan growth and higher fee income, partly offset by lower asset spreads due to higher funding costs. Loan impairment charges fell, notwithstanding the higher charges due to the combined effects of hurricane Katrina and changes in bankruptcy legislation. Profit before tax in Canada rose 93 per cent as net interest income increased due to strong asset and liability growth and widening deposit spreads.

Net interest income grew by 3 per cent to US\$11,636 million, mainly from increases in both the US and Canada. In the US, net interest income rose by 3 per cent, largely driven by higher deposit balances and widening deposit spreads. Average loan balances grew strongly, in particular from prime and non-prime residential mortgages. With ongoing strong demand for unsecured lending, the credit card, private label card and personal non-credit card portfolios continued to grow. The benefits of strong asset growth were largely offset by lower spreads as interest rates rose.

Additional resources were focused on the core retail banking business in the US as high priority was given to growing the deposit base. Investment in the retail branch network continued, to ensure a presence in locations with high growth potential. During the year, 27 new branches were opened, each tailored to meet the needs of

the local market. The launch of two new deposit products, HSBC's first national savings product, "Online Savings", and "HSBC Premier Savings", augmented by a 45 per cent rise in new personal account openings, led to a 4 per cent growth in average deposit balances to US\$26.7 billion.

Overall, average mortgage balances, including US\$3.3 billion held for resale, rose by 27 per cent to US\$112.1 billion. This was due to the significant expansion of ARMs originated during 2004 in the US bank and strong growth within the mortgage services and branch-based consumer lending

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Business Review

(continued)


North America > 2005

businesses. These volume benefits were largely offset by narrowing spreads as yields fell due to changes in product mix and higher funding costs.

Prime mortgages originated in 2005 were largely sold into the large government-sponsored mortgage associations, reflecting a strategic decision to focus on loans originated through the retail channel and reduce HSBC's reliance on lower spread business generated by the network of mortgage correspondents. The improvements in retail channel sales were achieved by capitalising on the HSBC brand, and the newly expanded branch network and customer base. As interest rates rose, demand for ARM products in 2005 declined as customers migrated towards longer-term fixed rate mortgages. ARM-originated loans fell from 67 per cent of all loans originated in 2004 to 30 per cent in 2005. Spreads narrowed on prime mortgages, largely because of higher funding costs and marginally lower yields, the latter due to the full year effect of the strong growth of lower-yielding ARMs originated in 2004.

HSBC continued to grow its sub-prime and near-prime mortgage portfolios, primarily within the mortgage services and branch-based consumer lending businesses. The mortgage services business, which purchases mortgage loans from a network of correspondents, recorded strong average loan growth of 42 per cent to US\$39.1 billion, of which US\$1.7 billion related to mortgages held for resale. Continued focus on growing the second lien portfolio, widening the first lien product offering and expanding sources for the purchase of loans from "flow" correspondents contributed further to the increase. Within the branch-based consumer lending business, average mortgage balances grew by 19 per cent to US\$35.7 billion, reflecting a combination of increased marketing activity and higher sales volumes of near-prime mortgages and ARMs, first introduced in the second half of 2004. In addition, the consumer lending business purchased US\$1.7 billion of largely sub-prime mortgage loans through a portfolio acquisition programme. The benefits of higher sub-prime and near-prime balances were largely offset by lower spreads. Yields fell due to the combined effects of strong refinancing activity, significant amounts of older higher-yielding loans seasoning, continued product expansion into the near-prime customer segments and competitive pricing pressures. The higher cost of funds due to rising interest rates also contributed to the decline in spreads.

Average loan balances within the consumer finance credit cards business rose by 7 per cent to US\$19.8 billion, despite the highly competitive

environment, where overall market growth remained weak. By increasing the level of marketing promotions, HSBC was able to grow organically the HSBC branded prime, Union Privilege and non-prime portfolios. The benefit of higher balances was more than offset by higher funding costs. Yields, however, improved due to a combination of higher-yielding sub-prime receivable balances, increased pricing on variable rate products and other re-pricing initiatives.

In the retail services cards business, average loan balances grew by 7 per cent to US\$15.9 billion. This growth was driven by new loan originations and the agreement of new merchant relationships with The Neiman Marcus Group Inc, Bon Ton Stores Inc and OfficeMax, which contributed US\$506 million of the overall increase. The benefit of higher loan balances was more than offset by lower spreads. Spreads declined as a large proportion of the loan book, priced at fixed rates, was affected by higher funding costs as interest rates rose. Spreads also narrowed as changes in the product mix reflected strong growth of lower-yielding recreational vehicle balances and external pricing pressures. Changes in contractual obligations associated with a merchant also had an adverse effect, but this resulted in lower merchant fees payable.

The vehicle finance business reported strong organic growth, with a 14 per cent increase in average loan balances, largely due to increases in the near-prime portfolio. This growth in balances was mainly driven by a combination of higher new loan originations acquired from the dealer network, in part due to the success of the [employee pricing] incentive programmes introduced by a number of the large car manufacturers, and strong growth in the consumer direct loan programme. A new strategic alliance helped grow loans further, generating US\$234 million of new balances. These volume benefits were largely offset by lower spreads, due to higher funding costs and lower yields. Yields fell due to product expansion into the near-prime portfolio, coupled with competitive pricing pressures due to excess market capacity.

Personal non-credit card average loan balances in the consumer finance business grew by 8 per cent to US\$16.0 billion, reflecting the success of several large direct mail campaigns and increased availability of this product in the US market. Improvements in underwriting processes, aided by continued improvements in the US economy, also contributed to the increase. These benefits were partly offset by lower spreads, due to higher funding costs.

[Back to Contents](#)

In Canada, net interest income grew by 21 per cent, due to growth in average loan and deposit balances, augmented by widening deposit spreads. Branch expansion in the consumer finance business generated higher average loan balances in real estate secured and unsecured lending. Credit card balances also grew, following the successful launch of a MasterCard programme.

Net fee income grew by 23 per cent to US\$3,050 million, driven by the strong performance in the US, where the 23 per cent increase was mainly from retail and credit card services, the mortgage banking business and the taxpayer financial services business. Fee income within the consumer finance credit cards business increased by 19 per cent, or US\$300 million, largely because of increased transaction volumes, loan balance growth and improved interchange rates. Greater use of the "intelllicheck" product, which enables customers to pay their credit card balances over the telephone, contributed an additional US\$33 million of revenues. Revenues from ancillary services rose by US\$77 million, reflecting higher sales volumes, new product launches and expansion into new customer segments.

Within the US retail services business, fee income rose, mainly because merchant partnership payments fell due to changes in contractual obligations with certain clients. In part, this reflected reduced loan spreads associated with the lower merchant payments.

Fee income from the US mortgage-banking business increased. As interest rates gradually rose, refinancing prepayments of mortgages declined, with levels of loan refinancing activity falling from 50 per cent of total loans originated in 2004 to 44 per cent in 2005. This led to lower amortisation charges and the subsequent release of temporary impairment provisions on mortgage servicing rights. In addition, the value of servicing rights was better protected by an improved economic hedging programme using a combination of derivative financial instruments and investment securities. A revised fee structure, introduced in the second half of 2004, produced a 6 per cent increase in fee income from deposit-related services in HSBC's US bank.

Within the US taxpayer financial services business, fee income grew by 12 per cent, driven by higher average loan balances and the sale of previously written-off loan balances. HSBC is the sole provider of bank products to H&R Block, the largest retail tax preparation firm in the US, and in September 2005 extended this arrangement by signing a new five-year contract. Since June 2004,

HSBC has retained in-house the clearing business for refund anticipation payments which was previously carried out by a third party. This generated additional revenues of US\$19 million for HSBC in the US.

In Canada fee income rose from higher investment management fees driven by growth in funds under management and higher credit card fee income from the consumer finance business.

Trading income in 2005 was 10 per cent lower. In the US mortgage banking business revenues increased, largely as a result of more originations and sales related income, which reflected improved gains on each individual sale and a 41 per cent increase in the volume of originated loans sold. In addition, a higher percentage of ARM loans that previously would have been held on balance sheet were sold in 2005. This was offset by lower gains on Decision One sales in the mortgage services business.

The increase in other income largely arose in the US. Losses from the sale of properties repossessed after customers had defaulted on their mortgage payments, which were recorded as a reduction in other income, were US\$96 million lower than in 2004. This was attributable to improvements in the process by which fair market value was determined at the time of repossession, and to a reduction in the number of properties falling into repossession as credit quality improved.

Loan impairment charges and other credit risk provisions of US\$5,001 million were 3 per cent lower than in 2004. In the US, charges were lower notwithstanding the adverse effect of hurricane Katrina and higher bankruptcy filings following changes in bankruptcy legislation. Partly offsetting the effect of these events was the non-recurrence of US\$47 million of charges which arose from the adoption in 2004 of Federal Financial Institutions Examination Council ("FFIEC") charge-off policies relating to retail and credit card balances. Excluding these factors, the lower charge reflected favourable credit conditions in the US. Higher levels of secured lending, continued targeting of higher credit quality customers and improvements in underwriting contributed to the

reduction. In Canada, charges were in line with prior year, as higher charges in the consumer lending business due to loan growth were offset by provision releases in the core bank business.

Operating expenses grew by 4 per cent to US\$6,317 million. In the US, costs increased by 3 per cent as staff and marketing expenses rose in the consumer finance business to support revenue

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Business Review

(continued)

North America > 2005

growth, and acquisition costs were incurred following the Metris purchase. In the credit cards business, marketing expenditure increased on the non-prime portfolios and from investment in new initiatives. Marketing expenses also rose following changes in July 2004 in contractual obligations associated with the General Motors co-branded credit card portfolio, but these were partly offset by improved income from lower account origination fees.

In HSBC's US bank, costs grew to support business expansion and new branch openings. Brand awareness programmes in the second and fourth quarters increased marketing costs, and expenditure was incurred on promoting the online savings product. The benefit of these initiatives was reflected in a significant increase in customer awareness of the HSBC brand. Within the retail brokerage business, cost increases reflected more stringent regulatory requirements.

In Canada, operating expenses grew, mainly due to the opening of new branches within the consumer finance business, and expansion of the mortgage and credit cards businesses.

Commercial Banking's pre-tax profits increased by 26 per cent to US\$892 million, primarily due to lending growth and improved liability interest spreads.

Net interest income increased by 19 per cent to US\$1,157 million. In the US, deposit growth, particularly among small businesses, contributed to a 20 per cent increase in net interest income. The recruitment of additional sales and support staff and expansion on both the East and West coasts led to a 15 per cent increase in deposits and a 16 per cent increase in lending balances, with income from commercial real estate lending rising by 27 per cent. HSBC achieved particularly strong growth in the SME market and maintained its market-leading position in small business administration lending in New York State. Following its launch in the first half of 2005, the "Select Investor" product, which offers competitive tiered interest rates, attracted US\$420 million of deposits. "Business Smart", a product offering free checking and other value offerings to commercial customers, performed strongly following its launch at the end of 2004, attracting 41,000 new customers and balances of over US\$1.0 billion.

In Canada, net interest income increased by 16 per cent as higher oil and other natural resource prices led to strong economic growth, and low interest rates increased demand for lending products. Average lending balances increased by 20 per cent,

as leasing balances grew by 33 per cent and commercial real estate lending rose by 19 per cent. Average deposit and current account balances increased by 21 per cent and 24 per cent respectively, reflecting the buoyant economy, the launch of HSBCnet in Canada and more brand advertising. Both asset and liability spreads were broadly in line with 2004.

Other income, including net fee income, increased by 7 per cent to US\$374 million as a result of higher gains on the sale of properties and investments in the US.

There was a US\$21 million net release of loan impairment charges compared with a net charge of US\$7 million in 2004. Significant releases in Canada were partly offset by higher charges, driven by lending growth, in the US. In Canada, improved credit quality led to a US\$34 million net release of loan impairment provisions. In the US, credit quality remained high in the favourable economic conditions, with the proportion of impaired loans to assets decreasing by 49 basis points.

Operating expenses increased by 8 per cent to US\$660 million, driven by the US where expansion in the SME and MME markets and in the commercial mortgage sector led to a 17 per cent increase in staff numbers. New MME offices were opened in Philadelphia and New Jersey, following the establishment of offices in Los Angeles and San Francisco in 2004. The launch of [Select Investor] and promotion of [Business Smart] led to higher marketing costs.

Corporate, Investment Banking and Markets reported a pre-tax profit of US\$573 million, 37 per cent lower than in 2004. The overall increase in revenue was exceeded by higher expenses, which reflected the full year cost of the expanded operations in the US and the continuing investment in a number of specific initiatives designed to build stronger execution and delivery capabilities.

Total operating income rose by 4 per cent. In the US and Canada, balance sheet management and money market revenues declined by US\$353 million as rising US dollar short-term interest rates led to further flattening of the yield curve.

Net interest income from the payments and cash management business in the US grew by 65 per cent, principally due to an 82 per cent growth in balances.

Net fees increased by 24 per cent, primarily due to higher volumes in Global Investment Banking, reflecting positive momentum from an extension of the product range, particularly in debt capital markets, where earnings grew by 67 per cent. Equity

[Back to Contents](#)

capital markets revenue improved from a low base and higher income streams were generated from a regular flow of new deals from asset-backed securities. Global Transaction Banking fees rose, reflecting higher customer volumes in payments and cash management.

Income from trading activities increased, due in part to higher revenues in the US from credit trading following losses in 2004, and a tightening of credit spreads. Business lines in which HSBC has invested, such as equities and structured derivatives, also showed strong year-on-year gains.

There was a reduction of US\$24 million in the net release of loan impairment allowances, primarily due to the non-recurrence of a number of large releases. New impairment allowances against corporate clients remained broadly in line with last year.

Operating expenses increased by 44 per cent to US\$1,376 million. In 2005, the proportionately greater investment in North America compared with other regions reflected HSBC's commitment to strengthen global reach by developing its presence in this region. HSBC continued to invest throughout the year in expanding product capabilities, particularly in structured derivatives, equities, research, mortgage-backed securities and advisory, and the build-out of specialist sector teams in the US. Nearly half of the incremental cost was attributable to this investment.

Staff costs rose by 40 per cent, reflecting the full year of recruitment in the latter part of 2004 and selective hiring in 2005 which resulted in an increase of 856 staff in Corporate, Investment Banking and Markets in North America.

Non-staff costs grew correspondingly and included the expense incurred in building critical infrastructure and investment in new technology.

Private Banking contributed a pre-tax profit of US\$104 million, an increase of 55 per cent on 2004, driven by growth in client assets and the balance sheet, and the expansion of Wealth and Tax Advisory Services (WTAS).

Net interest income increased by 11 per cent. Lending balances rose by over 30 per cent as clients borrowed on a secured basis to make alternative investments. Mortgage lending also grew, supported by the launch of a Tailored Mortgage product during the year. Spreads on current accounts increased by 40 basis points, reflecting the benefit of interest rate increases during the year.

A number of smaller trust accounts were sold in 2005, generating one-off income of US\$9 million. This was partly offset by the non-recurrence of gains from financial investments arising from the sale of seed capital investments in 2004. Having expanded its presence in New York, Philadelphia, Los Angeles, San Francisco and Virginia through the recruitment of fee-generating staff, and having grown organically from referrals, WTAS contributed to an increase of 13 per cent in fee income.

Client assets grew by 4 per cent to US\$40.8 billion, contributing to the rise in fee and other operating income. US\$1.8 billion of net new money reflected client acquisition in the US, partly offset by the divestment of trust accounts referred to above. The Strategic Investment Solutions product, launched in March 2004, was markedly successful in attracting new funds. Discretionary managed assets invested in this product reached US\$0.9 billion.

Operating expenses of US\$324 million were 9 per cent higher than in 2004. The recruitment of front office staff in Private Banking and new fee-generating staff in WTAS added to the cost base. This was partly offset by a reduction in staff numbers through restructuring and the sale of the trust account business referred to above.

Increased activity at HSBC's North American technology centre led to an increase in both costs and net operating income in **Other**, as higher network and systems maintenance costs and development expenditure to meet increased technological requirements were recharged to other customer groups. Movements in the fair value of own debt and the associated swaps designated at fair value led to a US\$401 million increase in total operating income.

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Business Review

(continued)

North America > Profit/loss before tax

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

Year ended 31 December 2006

North America	Personal Financial Services	Commercial Banking	Corporate, Investment Banking & Markets	Private Banking	Other	Inter- segment elimination	Total
	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m
Net interest income/(expense)	12,964	1,362	266	212	(52)	(484)	14,268
Net fee income/(expense)	3,675	329	656	240	(134)	□	4,766
Trading income/(expense) excluding net interest income	66	13	746	12	(220)	□	617
Net interest income/(expense) on trading activities	208	□	72	□	(23)	484	741
Net trading income/(expense)	274	13	818	12	(243)	484	1,358
Net expense from financial instruments designated at fair value	□	□	(11)	□	(52)	□	(63)
Gains less losses from financial investments	14	19	12	9	4	□	58
Dividend income	23	1	61	□	□	□	85
Net earned insurance premiums	492	□	□	□	□	□	492
Other operating income	270	87	269	31	1,536	(1,271)	922
Total operating income	17,712	1,811	2,071	504	1,059	(1,271)	21,886
Net insurance claims ¹	(259)	□	□	□	□	□	(259)

Net operating income before loan impairment charges and other credit risk provisions	17,453	1,811	2,071	504	1,059	(1,271)	21,627
Loan impairment charges and other credit risk provisions	(6,683)	(74)	(3)	(35)	(1)	□	(6,796)
Net operating income	10,770	1,737	2,068	469	1,058	(1,271)	14,831
Total operating expenses	(7,379)	(814)	(1,641)	(355)	(1,275)	1,271	(10,193)
Operating profit/(loss)	3,391	923	427	114	(217)	□	4,638
Share of profit/(loss) in associates and joint ventures	□	34	(4)	□	□	□	30
Profit/(loss) before tax	3,391	957	423	114	(217)	□	4,668
	%	%	%	%	%		%
Share of HSBC's profit before tax	15.4	4.3	1.9	0.5	(1.0)		21.1
Cost efficiency ratio	42.3	44.9	79.2	70.4	120.4		47.1
	US\$m	US\$m	US\$m	US\$m	US\$m		US\$m
Selected balance sheet data²							
Loans and advances to customers (net)	220,517	34,651	17,215	5,604	□		277,987
Total assets	250,985	43,012	208,958	6,558	1,677		511,190
Customer accounts	54,099	31,066	23,711	11,938	108		120,922
The following assets and liabilities were significant to Corporate, Investment Banking and Markets:							
loans and advances to banks (net)			15,862				
Trading assets, financial							

instruments designated at fair value, and financial investments ³	136,141
deposits by banks	9,664

88

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[Back to Contents](#)

Year ended 31 December 2005⁴

North America	Personal Financial Services US\$m	Commercial Banking US\$m	Corporate, Investment Banking & Markets US\$m	Private Banking US\$m	Other US\$m	Inter- segment elimination US\$m	Total US\$m
Net interest income/(expense)	11,636	1,157	661	185	(114)	(230)	13,295
Net fee income/(expense)	3,050	283	577	200	(158)	□	3,952
Trading income excluding net interest income	119	7	95	7	22	□	250
Net interest income/(expense) on trading activities	210	(4)	221	(1)	(21)	230	635
Net trading income	329	3	316	6	1	230	885
Net income/(expense) from financial instruments designated at fair value	10	□	23	(1)	402	□	434
Gains less losses from financial investments	(12)	1	57	□	1	□	47
Dividend income	8	□	33	□	□	□	41
Net earned insurance premiums	478	□	□	□	(1)	□	477
Other operating income	232	87	179	34	1,280	(1,170)	642
Total operating income	15,731	1,531	1,846	424	1,411	(1,170)	19,773
Net insurance claims ¹	(232)	□	□	□	□	□	(232)
Net operating income before loan impairment charges and other credit risk provisions	15,499	1,531	1,846	424	1,411	(1,170)	19,541
Loan impairment (charges)/recoveries and other credit risk provisions	(5,001)	21	64	4	(4)	□	(4,916)
Net operating income	10,498	1,552	1,910	428	1,407	(1,170)	14,625
Total operating expenses	(6,317)	(660)	(1,376)	(324)	(1,251)	1,170	(8,758)

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Operating profit	4,181	892	534	104	156	□	5,867
Share of profit in associates and joint ventures	□	□	39	□	9	□	48
Profit before tax	4,181	892	573	104	165	□	5,915
	%	%	%	%	%		%
Share of HSBC's profit before tax	19.9	4.3	2.7	0.5	0.8		28.2
Cost efficiency ratio	40.8	43.1	74.5	76.4	88.7		44.8
	US\$m	US\$m	US\$m	US\$m	US\$m		US\$m
Selected balance sheet data ²							
Loans and advances to customers (net)	207,598	29,666	10,381	4,915	□		252,560
Total assets	240,474	36,570	149,623	5,823	□		432,490
Customer accounts	44,769	25,585	31,442	9,589	1		111,386
The following assets and liabilities were significant to Corporate, Investment Banking and Markets:							
loans and advances to							
□ banks (net)			9,979				
trading assets, financial instruments							
□ designated at fair value, and financial investments ³			102,732				
deposits by							
□ banks			7,506				
			89				

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Business Review

(continued)

North America > Profit/(loss) before tax / Latin America

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

Year ended 31 December 2004⁴

	Personal Financial Services US\$m	Commercial Banking US\$m	Corporate, Investment Banking & Markets US\$m	Private Banking US\$m	Other US\$m	Inter- segment elimination US\$m	Total US\$m
North America							
Net interest income/(expense)	11,998	948	780	166	(105)	□	13,787
Net fee income/(expense)	2,461	191	458	176	(89)	□	3,197
Trading income	195	8	299	6	1	□	509
Gains less losses from financial investments	72	□	68	6	1	□	147
Dividend income/(expense)	14	□	20	□	(2)	□	32
Net earned insurance premiums	450	□	□	□	□	□	450
Other operating income/(expense)	(13)	145	126	4	1,065	(986)	341
Total operating income	15,177	1,292	1,751	358	871	(986)	18,463
Net insurance claims ¹	(236)	□	□	□	□	□	(236)
Net operating income before loan impairment charges and other credit risk provisions	14,941	1,292	1,751	358	871	(986)	18,227
Loan impairment (charges)/recoveries and other credit risk provisions	(5,118)	(7)	88	2	(1)	□	(5,036)
Net operating income	9,823	1,285	1,839	360	870	(986)	13,191
Total operating expenses	(5,997)	(594)	(945)	(292)	(1,073)	986	(7,915)
Operating profit/(loss)	3,826	691	894	68	(203)	□	5,276
Share of profit/(loss) in associates and joint ventures	□	□	(15)	□	7	□	(8)
Profit/(loss) before tax	3,826	691	879	68	(196)	□	5,268

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	%	%	%	%	%	%
Share of HSBC's profit before tax	20.2	3.6	4.6	0.4	(1.0)	27.8
Cost efficiency ratio	40.1	46.0	54.0	81.6	123.2	43.4
	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m
Selected balance sheet data ²						
Loans and advances to customers (net)	185,539	25,354	25,387	3,871	□	240,151
Total assets	217,307	28,818	97,435	4,538	34	348,132
Customer accounts	40,981	23,112	45,636	7,822	□	117,551

The following assets and liabilities were significant to

Corporate, Investment Banking and Markets:

loans and advances						
□ to banks (net)			20,550			
□ trading assets, financial instruments designated at fair value, and financial investments ³			41,849			
□ deposits by banks			13,611			

1 Net insurance claims incurred and movement in policyholders' liabilities.

2 Third party only.

3 Including financial assets which may be repledged or resold by counterparties.

4 In 2006, Mexico and Panama were reclassified from the North America segment to the Latin America segment. Comparative information has been restated accordingly.

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

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

	Year ended 31 December		
	2006 US\$m	2005 ¹ US\$m	2004 ¹ US\$m
Personal Financial Services	800	786	651
Mexico	628	570	549
Brazil	121	167	98
Argentina	35	37	(5)
Other	16	12	9
Commercial Banking	451	357	316
Mexico	197	161	140
Brazil	185	147	108
Argentina	51	35	50
Other	18	14	18
Corporate, Investment Banking and Markets	475	347	196
Mexico	177	192	85
Brazil	218	95	92
Argentina	68	56	8
Other	12	4	11
Private Banking	14	1	□
Mexico	7	□	□
Brazil	6	1	1
Other	1	□	(1)
Other	(5)	113	79
Mexico	□	□	□
Brazil	(4)	(4)	(18)
Argentina	3	116	101
Other	(4)	1	(4)
Total	1,735	1,604	1,242
Mexico	1,009	923	774
Brazil	526	406	281
Argentina	157	244	154
Other	43	31	33

¹ In 2006, Mexico and Panama were reclassified from the North America segment to the Latin America segment. Profit/(loss) before tax in 2005 and 2004 has been restated accordingly.

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

Economic briefing

Mexico's GDP growth improved significantly in 2006 to 4.8 per cent from 3.0 per cent in 2005, mostly in response to increased external demand from the US. Commercial bank credit continued to recover strongly, with over 80 per cent growth in real mortgage loans. By the end of 2006, headline inflation had increased to 3.8 per cent from 3.0 per cent earlier in the year, largely as a result of increases in agricultural supply prices. Record oil revenues, combined with high non-oil export growth and increasing inward remittances from Mexicans working outside the country produced an almost balanced current account for the year. Significant capital inflows, including an estimated US\$18 billion in foreign direct investment, enabled the Government to reduce its external debt by more

than US\$12 billion and the Bank of Mexico to increase foreign exchange reserves.

In **Brazil**, GDP is expected to have grown by 2.6 per cent in 2006 compared with 2.3 per cent in 2005. Growth was driven by domestic demand, with private consumption increasing by 3.8 per cent and capital spending by 5.9 per cent. Net exports, by contrast, fell by 18 per cent in the first three quarters of the year compared with the same period in 2005, as the increase in domestic demand translated into higher imports rather than an expansion of output. The unemployment rate averaged 10.0 per cent in 2006, slightly up from 9.8 per cent averaged in 2005. Inflation continued to decline, to 3.1 per cent in 2006, compared with 5.7 per cent in 2005 and, as a result, the Central Bank continued to ease monetary policy. Overnight rates fell to 13.25 per cent in December 2006 from 17.25 per cent a year before. The trade balance continued to be

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Business Review

(continued)

Latin America > 2006

Profit before tax

	Year ended 31 December		
	2006 US\$m	2005 ¹ US\$m	2004 ¹ US\$m
Latin America			
Net interest income	4,197	3,342	2,516
Net fee income	1,630	1,191	1,027
Trading income	537	537	127
Net income from financial instruments designated at fair value	237	186	□
Net investment income on assets backing policyholders' liabilities	□	□	95
Gains less losses from financial investments	84	80	47
Dividend income	6	5	2
Net earned insurance premiums	1,076	871	699
Other operating income	91	286	46
Total operating income	7,858	6,498	4,559
Net insurance claims incurred and movement in policyholders' liabilities	(1,023)	(792)	(535)
Net operating income before loan impairment charges and other credit risk provisions	6,835	5,706	4,024
Loan impairment charges and other credit risk provisions	(938)	(676)	(253)
Net operating income	5,897	5,030	3,771
Total operating expenses	(4,166)	(3,426)	(2,530)
Operating profit	1,731	1,604	1,241
Share of profit in associates and joint ventures	4	□	1
Profit before tax	1,735	1,604	1,242
	%	%	%
Share of HSBC's profit before tax	7.9	7.7	6.5
Cost efficiency ratio	61.0	60.0	62.9
Year-end staff numbers (full-time equivalent)	67,116	55,600	52,473
	US\$m	US\$m	US\$m
Selected balance sheet data²			
Loans and advances to customers (net)	35,791	21,681	15,693
Loans and advances to banks (net)	12,634	8,964	5,892
Trading assets, financial instruments designated at fair value, and financial investments	20,497	16,945	12,327
Total assets	80,771	55,387	40,419
Deposits by banks	5,267	2,598	2,244
Customer accounts	50,861	30,989	26,307

- 1 *In 2006, Mexico and Panama were reclassified from the North America segment to the Latin America segment. Comparative information has been restated accordingly.*
- 2 *Third party only.*

robust, with a surplus of US\$46.1 billion in 2006, just above the amount achieved in 2005.

In **Argentina**, real GDP growth in 2006 exceeded 8.3 per cent and, after growing for four consecutive years at an average rate of approximately 9 per cent, the country's GDP was nearly 15 per cent above 1998, when its recession began. The strong growth was due to a competitive exchange rate, a strong fiscal stance and a favourable business environment, which HSBC expects to continue in 2007. The main potential constraint on growth remains the risk of disruption in energy supply, where there has been a lack of investment and limited

price adjustments for residential consumers since 2001/2. Inflation was approximately 10 per cent at the end of 2006, having tripled in the past three years, though it was below its peak of more than 12 per cent in 2005. Interest rates rose steadily in 2006 and the peso weakened slightly against the US dollar. Given Argentina's higher inflation rate, however, the exchange rate appreciated in real terms.

Review of business performance

HSBC's operations in Latin America reported a pre-tax profit of US\$1,735 million compared with US\$1,604 million in 2005, an increase of

[Back to Contents](#)

8 per cent. On an underlying basis, pre-tax profits rose by 5 per cent. Growth in profitability was constrained by the non-recurrence of one-off coverage bond receipts and other items related to the 2001 sovereign debt default and subsequent pesification in Argentina, which added US\$122 million to 2005 profits. In addition, a gain of US\$89 million from the sale of the property and casualty insurance business, HSBC Seguros de Automoveis e Bens Limitada, to HDI Seguros S.A., was recorded in 2005. Excluding these prior year profits, and on an underlying basis, profit before tax increased by 21 per cent, with net operating income increasing by 15 per cent and operating expenses by 12 per cent. Corporate, Investment Banking and Markets delivered a strong performance, driven by growth in fee and trading income, with notable success in bringing Latin American borrowers to global capital markets. Commercial Banking also grew well as domestic economies expanded. During 2006, HSBC made two significant acquisitions in the region. In May, HSBC acquired the Argentine banking operations of Banca Nazionale del Lavoro SpA (Banca Nazionale) to build its distribution capabilities and, in November, Grupo Banistmo in Central America, adding markets in five countries new to the Group.

The following commentary is on an underlying basis.

Personal Financial Services reported a pre-tax profit of US\$800 million, a rise of 1 per cent over 2005, which had benefited from a US\$89 million gain on the sale of the Group's property and casualty insurance business in Brazil. Adjusting for this, pre-tax profits grew by 16 per cent, driven by 12 per cent growth in revenues and 10 per cent growth in costs. The underlying improvement in revenues was led by strong asset and deposit growth together with higher fee income, offset in part by consequential expense growth and a rise in impairment charges as the loan book both grew and seasoned.

In Mexico, profit before tax rose by 10 per cent. During 2006, 56,000 Personal Financial Services customers were transferred to the Commercial Banking customer group, where HSBC is better placed to meet their banking requirements. Adjusting for this, profits were 20 per cent higher, driven by strong balance sheet growth and improved fee income.

Adjusting for the gain in 2005 from the sale of the property and casualty business, pre-tax profits were 46 per cent higher in Brazil. The strong domestic economy stimulated robust growth in lending and a rise in the number of current account

holders. During the year, a new and innovative internet banking service Meu HSBC was introduced to Personal Financial Services customers, allowing them to conduct different types of transactions online using the same password as their ATM card.

In Argentina, profit before tax was marginally higher, with strong balance sheet growth, higher fees and improved revenues from the insurance business. This was largely offset by increased loan impairment charges and cost growth incurred in support of business expansion as HSBC prepared for an improving domestic economic environment.

Net interest income rose by 11 per cent to US\$3,057 million, largely from balance sheet growth partly offset by lower deposit spreads.

In Mexico, net interest income increased by 12 per cent to US\$1,218 million. Adjusting for the effect of customer account transfers to Commercial Banking, net interest income rose by 20 per cent, driven by strong growth in credit card and mortgage balances and increases in deposits which were generated by the ongoing success of the Tu Cuenta product. Overall, asset spreads improved as the relative increase in higher margin card balances led to a favourable change in the product mix. By contrast, deposit spreads narrowed as interest rates declined.

Excluding customer account transfers, average deposit balances in Mexico rose by 10 per cent. HSBC continued to be one of the market leaders with respect to balance growth, despite fierce competition from other banks, improving its market share by 35 basis points. A strong increase in low-cost deposits was reflective of the continuing success of Tu Cuenta, the first integrated financial services product of its kind offered locally, with nearly 400,000 new accounts opened in 2006. HSBC Premier performed well as 84,000 new customers were added during the year. Premier deposits represented over one third of the total personal deposit base at 31

December 2006. The income benefit from higher deposit balances was partly mitigated by reduced spreads in the falling interest rate environment, notwithstanding the positive shift in mix from growth in non-interest bearing deposit balances.

The credit card market in Mexico was buoyant in 2006 and HSBC's business performed very successfully with average balances doubling to US\$886 million. Various initiatives were implemented to develop the business, most notably cross-sales to "Tu Cuenta" customers, targeted customer relationship campaigns to existing clients, successful portfolio management strategies and promotions, development of new sales channels and

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Business Review

(continued)

Latin America > 2006

improvements in card activation times. These initiatives helped HSBC become the market leader in credit card balance growth, improving market share by 2.3 per cent. The number of cards in circulation reached 1.7 million at the year end, representing an increase of 76 per cent.

Demand for housing from first time buyers remained strong in Mexico, and market conditions continued to be highly competitive. Average mortgage balances rose by 81 per cent to US\$969 million, reflecting HSBC's competitive pricing and innovation in product design. HSBC was the first bank in Mexico to market pre-approved online mortgages, and enhanced this offering with the subsequent introduction of [Mortgage Express Approval], which provides customers with much faster access to details concerning the loan amount, duration and monthly payments at the point of application. Improvements in the processing of mortgage applications, upgraded customer service and increased marketing activity also contributed to the rise in lending balances. The income benefits of balance growth were partly offset by narrower spreads, driven by the highly competitive market conditions.

As the Mexican economy grew strongly, there was robust growth in personal and payroll lending balances. The introduction of a dedicated and mobile sales force during the second half of 2006 to expand distribution capabilities led to a fourfold increase in average personal lending balances during the year. This initiative also helped to reduce time to market, increase cross-sales and, through closer interaction with the branch network, improve client coverage. The popularity of the personal loan product, where customers apply directly via HSBC's extensive and well-positioned ATM network grew, and this was the key driver behind a 37 per cent rise in average payroll loan balances.

In Brazil, net interest income increased by 9 per cent as lower inflation and the improving domestic economy triggered a rise in demand for credit which, in turn, contributed to strong lending growth. Average loan balances were 18 per cent higher, driven by rising customer numbers and increases in vehicle financing, pension and payroll loans. On the liability side, there was a 7 per cent rise in current account holders, largely driven by growth in the number of customers with payroll loans and greater levels of sales activity.

Average vehicle finance balances in Brazil rose by 36 per cent, led by continued portfolio growth as HSBC strengthened its relationships with car dealerships. The combined pension and payroll loan

portfolios registered an 84 per cent increase in average balances, a consequence of increased borrowings per customer, portfolio acquisitions, and growing customer demand for these products. Spreads also improved, largely as a result of lower funding costs, which augmented the positive income benefits of balance growth. Average card balances rose by 19 per cent, with an increase of 27 per cent in the number of cards in issue, reflecting the launch of various initiatives aimed at improving retention, activation and utilisation. Spreads improved from lower funding costs and price increases initiated in the second half of 2005, complementing the benefits derived from higher lending volumes.

In Argentina, net interest income grew by 12 per cent, primarily driven by increased demand for credit card, other personal and motor vehicle lending. This was largely attributable to more effective promotional activity and productivity improvements in the telemarketing and branch channels. Higher funding costs, however, resulted in a narrowing of lending spreads, offsetting volume benefits. Deposit balances rose, reflecting the increased emphasis placed on growing liability products, the benefit from which was augmented by a widening of spreads.

Net fee income was 25 per cent higher, reflecting strong growth across the region generally.

Fee income grew by 21 per cent in Mexico, largely due to higher credit card and "Tu Cuenta" income. Fee income from cards rose by 51 per cent, reflecting a significant growth in the number of cards in circulation and improvements made in reducing activation times. The improvement in "Tu Cuenta" income was driven by sales of over 1 million new accounts and re-pricing initiatives. In order to capture a higher volume of ATM revenues, HSBC added 372 new machines to its already well-positioned network, which increased ATM fees from greater levels of transactional activity and a 22 per cent rise in transactions from non-HSBC customers. Growth in mutual fund fees was mainly driven by higher sales volumes and expanded product offerings in the stronger economic environment.

Fee income in Brazil rose by 25 per cent, largely from increased current account fees, reflecting growth in customer numbers, greater transaction volumes and re-pricing initiatives. Higher payroll and vehicle balances also led to increased fees from lending activities. In Argentina, higher credit card fees from balance growth, re-pricing initiatives on savings accounts, and the discontinuance of a free current account promotion led to an improvement in fee income.

[Back to Contents](#)

Across the region, HSBC's insurance businesses continued to perform well. Sales of insurance products in Mexico remained strong, with increased cross-selling through the branch network of simple insurance products together with other Personal Financial Services products containing insurance components. This led to a 19 per cent rise in net premiums, mainly in respect of individual life insurance products. In Brazil, excluding the effect of the property and casualty insurance business sold in 2005, insurance revenues rose, largely from life and pension products. In Argentina, increased advertising, partnerships with established local consumer brands and internal cross-selling initiatives led to a rise in motor, home and extended-warranty insurance premium income. Life and annuity premiums also increased in line with higher customer salaries. The "Maxima" pension funds business delivered higher revenues helped by improvements in the economic climate and greater levels of employment.

Lower other operating income reflected the non-recurrence of profit on the sale of HSBC's Brazilian property and casualty insurance business.

Loan impairment charges and other credit risk provisions rose by 15 per cent to US\$764 million as lending grew and the loan book seasoned. In Mexico, the higher charge was primarily driven by the growth in credit card lending. In Brazil, loan impairment charges increased modestly, driven by growth in vehicle finance, instalment loans ("credito parcelado") and credit card lending. As the credit environment weakened during the first half of the year, various measures were taken to mitigate the effects. These included tightening lending criteria, enhancing credit analytics, revising the collection policy, prioritising secured lending ahead of unsecured advances and strengthening credit operations. Following implementation of these measures, several key credit indicators showed improvement.

Operating expenses rose by 10 per cent. In Mexico, expense growth of 10 per cent was mainly driven by increased staff costs. This largely reflected the recruitment of 2,200 employees to improve customer service levels in branches and grow sales. Incentive costs increased as profits rose, and marketing costs grew as a result of various promotional campaigns. The continued expansion of the branch network and ATM infrastructure, together with the new HSBC headquarters building in Mexico City, led to increases in IT, premises and equipment costs.

In Brazil, expenses were 10 per cent higher. As in Mexico, this reflected the cost of new employees recruited to support business expansion, including the strengthening of credit operations, and new branch openings. This, together with annual pay rises and increased incentive payments, triggered a 13 per cent growth in staff costs. Advertising costs rose to promote brand awareness, while an HSBC *Premier* promotion led to higher marketing costs.

Costs grew by 26 per cent in Argentina, with higher staff costs driven by union-agreed pay rises in 2005, and increased incentives and commissions paid in light of revenue growth. Marketing costs also increased to support the launch of various promotions and campaigns.

Commercial Banking reported pre-tax profits of US\$451 million, 17 per cent higher than in 2005. Growth in net operating income before loan impairment charges was strong at 26 per cent as domestic economies in the region grew and HSBC built market share. Cost growth in support of this expansion was held within revenue growth and the cost efficiency ratio improved by 2.5 per cent.

Net interest income rose by 24 per cent, largely driven by business expansion in Mexico and Brazil.

In Mexico, net interest income rose by 49 per cent, reflecting asset and deposit growth, in part due to the transfer of the 56,000 customers from Personal Financial Services noted above. As HSBC extended its presence in the small and middle market business segments, average deposit balances increased by 65 per cent (31 per cent excluding the transferred customer accounts), although the benefit of this volume growth was partly mitigated by lower deposit spreads in a falling rate environment.

Lending balances in Mexico were 41 per cent higher, primarily driven by strong demand in the rapidly growing real estate and residential construction sectors. During the final quarter of the year, HSBC opened an

International Banking Centre to develop cross-border business for global Commercial Banking customers, with 75 business accounts acquired since its inception. Attention placed on higher yielding small and middle market businesses, following refinements made to the customer segmentation strategy, contributed to asset growth as greater emphasis was put on increasing revenues from this segment. These volume benefits were augmented by improved lending spreads from lower funding costs in the falling interest rate environment, which offset reduced yields.

In Brazil, net interest income was 12 per cent higher. Overall, lending balances rose by 16 per cent,

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Business Review

(continued)

Latin America > 2006 / 2005

primarily driven by small and middle market customers. The recruitment of additional relationship managers and sales staff, investments made in receivables financing and greater levels of promotional activity all combined to build HSBC's position in this market segment. There was ongoing success from the *giro fácil* product, offering both revolving loan and overdraft facilities, with average balances recording a 13 per cent increase. Spreads widened as interest rates fell, further augmenting the income benefits of higher lending volumes.

A 42 per cent rise in net interest income in Argentina was primarily attributable to strong asset and liability growth. Average lending and deposit balances increased by 39 per cent and 19 per cent respectively, as customer numbers rose, particularly to the small and micro businesses, helped by favourable economic conditions and investment in new sales channels. Asset spreads declined, however, due to competitive market pressures on pricing, partly offsetting the income benefits of higher lending volumes. By contrast, deposit spreads improved.

Net fee income was 36 per cent higher, driven by robust increases across Mexico, Brazil and Argentina.

In Mexico, fee income rose by 28 per cent with notable success in increasing cross-sales activity. Growth in customer numbers contributed to higher transactional volumes which, combined with an expanded and improved product offering plus increased marketing activity and re-pricing initiatives, led to a 41 per cent rise in income from payments and cash management services. The *Estimulo* product offering, comprising a packaged suite of seven different products including a loan facility, continued to perform well with fee income nearly trebling compared with 2005. During the third quarter, a similar product, *Estimulo Empresarial* was launched, targeting upper-end small business customers. This product encompasses a suite of eleven different services and since its introduction more than 165 clients have been signed, generating US\$50 million of new loans. HSBC's share of the trade services market continued to grow, building on the Group's international network and product capabilities. Fees from international factoring and domestic invoicing payment products also rose, as new products were successfully piloted and marketed to existing clients. The signing of new merchant customers led to higher transaction volumes and a subsequent 60 per cent rise in card acquiring fees.

In Brazil, fee income rose by 47 per cent as effective cross-selling led to an increase in the average number of products held per customer. Current account fee income grew from higher levels

of transactional activity and tariff increases implemented in 2005. Pricing changes introduced part-way through 2006 led to higher revenues from payment and cash management services. There was improved fee income from assets under management, and additional marketing to promote trade products led to a rise in trade services fees.

Fee income in Argentina was 27 per cent higher, primarily from increases in account and trade services along with payments and cash management fees.

Loan impairment charges and other credit risk provisions doubled, reflecting strong lending growth, a higher proportion of small and micro business lending, and the seasoning of the portfolio.

In Mexico, strong growth in the lower-end small and micro business lending balances led to increased loan impairment charges during the year.

A 41 per cent rise in Brazil again reflected large increases in small and micro business lending balances and higher delinquency rates as the portfolio seasoned. This led to a 12 basis point increase in the proportion of

impaired loans to assets. Various actions were undertaken to manage the effects of the weakening credit environment, with debt collection operations enhanced and closer cooperation forged between sales and collections staff. Changes were also made to underwriting criteria, coupled with revisions to sales staff incentive schemes. Following these measures, an improvement in credit quality was seen and charges reduced in the second half of the year compared with the first half. In Argentina, releases were lower than in 2005.

Operating expenses of US\$822 million were 21 per cent higher than in 2005, as businesses expanded strongly across Latin America.

In Mexico, operating expenses rose by 26 per cent, largely driven by higher transactional volumes, new clients acquired and increased lending activity. Non-staff costs were higher, reflecting the marketing and IT-related support to business growth.

In Brazil, expenses grew by 19 per cent, also largely from higher staff, marketing and administrative costs. Business expansion activities in the small and middle market customer segments followed the recruitment of 270 additional employees and this, together with union-agreed pay increases, were the principal drivers behind the 21 per cent rise in staff costs. Continued enlargement of the branch network, the opening of an International Banking Centre and new sales offices combined with increases in marketing and administration costs in support of business expansion, contributed further to cost

[Back to Contents](#)

growth. Costs in Argentina rose by 30 per cent, primarily staff costs which reflected annual pay increases and additional headcount driven by accelerated business activity. In supporting the growth of the business, there was increased expenditure on branding, technology and distribution, with ongoing improvements made to the internet banking service.

Corporate, Investment Banking and Markets reported a pre-tax profit of US\$475 million, an increase of 30 per cent compared with 2005. HSBC's strong global presence, together with selective investment in extending service and delivery capabilities in the region, resulted in higher volumes with new and existing clients. The cost efficiency ratio improved moderately.

Total operating income increased by 23 per cent to US\$846 million compared with 2005. In Brazil, balance sheet management revenues grew significantly as relatively low short-term interest rates reduced funding costs. In Argentina, higher net interest income reflected an increase in index linked securities portfolios and a growing demand for credit as regional economies and market confidence continued their recent improvement. By contrast, in Mexico, balance sheet management revenues were constrained by a flattening of the interest rate curve and relatively stable market conditions.

Net interest income from payments and cash management rose by 64 per cent as customer volumes grew, reflecting new client mandates.

Net fee income increased by 29 per cent to US\$167 million, predominantly through increased performance-related fees on emerging markets funds managed by Group Investment Businesses. Income in HSBC Securities Services benefited from strong equity market indices and growth in new business as assets under custody increased significantly to US\$89 billion.

In Mexico, a 32 per cent rise in payments and cash management fees was driven by a wider product offering and the leveraging of established credit related products and services.

Higher revenues from trading activities in Brazil flowed from marketing the wider product range and enhanced delivery capabilities of Global Markets. Greater volatility in local markets resulted in higher business volumes in foreign exchange and currency derivatives. In Argentina, economic and political stability increased liquidity in the market with foreign exchange trading benefiting from greater customer activity. In Mexico, a 23 per cent increase in trading income was driven by a combination of successful

positioning for a flattening yield curve and higher client volumes delivered through the extended suite of products.

A net release of US\$26 million in loan impairment charges reflected a stable corporate credit environment and the implementation of improved risk management strategies in Mexico.

Operating expenses rose by 20 per cent to US\$346 million, primarily driven by higher staff costs reflecting increased performance-related incentives in line with revenue growth, and pay rises agreed with local unions. Higher operational costs reflected increased volumes, particularly in payments and cash management and securities services businesses, and the continued investment in building the Corporate, Investment Banking and Markets' business in the region.

Private Banking reported a pre-tax profit of US\$14 million, a significant increase on 2005. Profit growth was strong in both Mexico and Brazil. In Brazil, revenue and cost benefits arose from initiatives to join up the business, including cross-referrals with other customer groups. Strong revenue growth in the newly launched business in Mexico resulted primarily from greater client participation in capital markets, notably commercial paper placements, which contributed towards a 53 per cent rise in fee income. This strong performance was reflected in the cost efficiency ratio which improved by 23.4 percentage points to 65.9 per cent.

Within **Other**, the non-recurrence of coverage bond receipts and other items related to the 2001 Argentinean sovereign debt crisis led to lower earnings.

Year ended 31 December 2005 compared with year ended 31 December 2004

Economic briefing

Mexico GDP growth was 3.0 per cent compared with 4.2 per cent in 2004, in line with lower external demand from the US. The fiscal accounts for the year showed a reduced deficit of 0.9 per cent, mostly from windfall earnings from high oil prices. As in 2004, high oil receipts and increasing levels of workers' remittances helped minimise the current account deficit at an estimated less than 1 per cent of GDP. The biggest achievement was the reduction in headline inflation from 5.2 per cent at the end of 2004 to 3.3 per cent in December 2005, with core inflation finishing the year at 3.1 per cent. HSBC viewed macroeconomic stability as encouragingly robust ahead of what looks likely to be a keenly contested presidential election in mid-2006.

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Business Review

(continued)

Latin America > 2005

In **Brazil**, the cyclical slowdown which began in late 2004 continued throughout 2005, with full-year GDP growth of 2.3 per cent compared with 4.9 per cent in 2004. This modest performance was the result of tight monetary policy, political uncertainty and the appreciation of the Brazilian real. External demand provided support, with exports growing by 23 per cent in 2005 to record levels, helping to create trade and current account surpluses of US\$45 billion and US\$14 billion respectively, and increasing net international reserves by 96 per cent to US\$54 billion. The tight monetary policy, with real interest rates among the highest in the world at 10.5 per cent, slowed inflation from 7.6 per cent in 2004 to 5.7 per cent in 2005, in line to achieve the Central Bank's 4.5 per cent inflation target for 2006. Having established its anti-inflationary credentials, the Central Bank cut interest rates by 175 basis points between September and the end of 2005 in order to stimulate growth and ease the pressure on the real.

In **Argentina**, the recovery from the crisis of 2001 continued in 2005, helped by a favourable external environment and the success of the offer to exchange replacement discount bonds issued in June for defaulted debt. Average GDP growth was 9.1 per cent in 2005. Fiscal performance remained strong, with the public sector posting an overall surplus of approximately 3.3 per cent of GDP. This surplus helped to offset the expansionary effect on money supply growth of the large foreign exchange interventions of the Central Bank, which continued to pursue a nominal rate policy of near stability against the US dollar despite strong upward pressure on the Argentine peso. This policy was supported by newly introduced controls on capital inflows. Inflation remained a concern, however, having accelerated to 12.3 per cent in December 2005. Following the example of Brazil, at the end of the year the authorities decided to make an early repayment of Argentina's US\$9.8 billion debt owed to the IMF.

Review of business performance

HSBC's operations in Latin America reported a pre-tax profit of US\$1,604 million, compared with US\$1,242 million in 2004, representing an increase of 29 per cent. On an underlying basis, pre-tax profits grew by 19 per cent and represented around 8 per cent of HSBC's equivalent total profit. Growth was achieved, in part, as a result of a US\$89 million gain on the sale of Brazil's property and casualty insurance business. In Mexico, robust balance sheet growth drove higher profit before tax and HSBC in Argentina benefited from a strong economic recovery and certain one-off items including the receipt of compensation bonds.

The commentary that follows is on an underlying basis.

Personal Financial Services reported a pre-tax profit of US\$786 million, an increase of 13 per cent. In Mexico, excluding the transfer of some customers to the Commercial Banking segment, pre-tax profits rose. This was driven by strong revenue growth from higher deposit balances and widening spreads, strong loan growth and higher fee income, partly offset by the non-recurrence in 2005 of loan impairment provision releases in 2004.

The rise in pre-tax profits in Brazil was partly as a result of gains on the sale of the property and casualty insurance business, with the remaining increase driven by strong loan growth in vehicle finance and personal lending, together with record credit card sales. The cost efficiency ratio improved by 2 percentage points as higher income was partly offset by increased costs incurred in supporting business expansion and developing alternative sales channels. Loan impairment charges increased reflecting, in Brazil, lending growth and an increase in delinquency rates in the consumer finance business and, in Mexico, higher charges from increased lending and the non-recurrence in 2005 of loan impairment provision releases in 2004. In 2005, the Brazilian insurance business was transferred from "Other" to Personal Financial Services. Profit before tax increased by US\$16 million as a result, though individual account lines showed much larger variances: where appropriate, the

reasons are noted below.

Net interest income rose by 27 per cent compared with 2004. Consumer demand for credit remained strong, fuelled by lower unemployment across the region and declining inflation in Brazil and Mexico. This contributed to significant growth in personal lending, mortgages, vehicle finance loans and credit cards.

In Mexico, net interest income rose, primarily from strong deposit and loan growth and the widening of deposit spreads. In 2005, HSBC in Mexico widened its competitive funding advantage, maintaining the lowest funding cost in the market. There was strong growth in consumer lending, although asset spreads declined, reflecting a reduction in yields in an increasingly competitive market. Funding costs rose, due to higher average interest rates.

HSBC in Mexico continued to lead the market in customer deposit growth, with a 1.5 per cent increase in market share to 15.9 per cent despite a highly competitive market place. This was largely due to the success of [Tu Cuenta], the only integrated financial

[Back to Contents](#)

services product of its kind offered locally. From its launch in February 2005, over 600,000 accounts were opened in the year, averaging some 2,300 new customers per day.

The continued success of HSBC's competitive fixed rate mortgage product in Mexico, helped by strong demand from first time buyers, led to average mortgage balances increasing by 93 per cent to US\$522 million and market share reaching 10.7 per cent. In Mexico, HSBC continued to be the leader in vehicle finance with a market share of 26.5 per cent. A unique new internet-based product "Venta Directa" was launched during the year, enabling the direct sale of used cars between customers using HSBC's financing and website as the intermediary. The targeting of new customer segments and more competitive pricing drove average vehicle finance loans higher by US\$228 million to US\$796 million, a 40 per cent increase over 2004. Average payroll loan balances more than doubled to US\$253 million, reflecting HSBC's unique ability in the market to grant pre-approved personal loans through its ATM network. Average credit card balances were 55 per cent higher, with cards in circulation increasing by 80 per cent to over 1.1 million cards. This was largely driven by cross-selling to the existing customer base using CRM systems and the successful launch of the "Tarjeta inmediata" or Instant credit card, which generated 109,000 new cards.

In Brazil, HSBC continued to position itself for future growth, investing in infrastructure to ensure the delivery of integrated solutions to customers. Enhancements to distribution, together with marketing campaigns and promotions, including partnerships with motor finance dealers, drove a 49 per cent rise in vehicle finance loans.

A combination of increased customers and targeted marketing initiatives contributed to a 40 per cent growth in personal lending. Personal lending balances also benefited from the successful launch in the first half of 2005 of pension-linked loans offering attractive rates of interest, with repayments drawn directly from the borrower's pension income. Balances of pension-linked loans increased to US\$110 million, partly as the result of an agreement to acquire the pension-linked loan production of Banco Schahin, a local bank.

The cards business continued to expand, due to both the continued strength of consumer expenditure and the launch of a private label card with Petrobras gas stations in 2004. During 2005, HSBC improved its competitive position, issuing over a million credit cards and having over two million in circulation, an increase of 21 per cent. Card utilisation grew and

cardholder spending increased, while average card balances rose by 30 per cent to US\$373 million. Credit card spreads increased as HSBC repositioned its card proposition by increasing interest rates to fall broadly in line with the bank's major competitors.

In Argentina, HSBC focused on pre-approved sales mailings and on developing direct sales channels. Net interest income more than doubled, driven by a 59 per cent increase in asset balances. The strong demand for credit resulted in personal unsecured lending more than doubling. Credit cards in circulation increased by 25 per cent, following a discount campaign launched in June 2005 and the launch of a private label card with C&A which contributed to a 53 per cent increase in card balances. Savings and deposit balances increased by 34 per cent, reflecting the improved economic environment.

Net fee income decreased by 7 per cent, as increases in Mexico and Argentina were more than offset by a significant reduction in Brazil.

HSBC in Mexico reported strong growth in fee income, driven by higher revenues from credit cards, remittances, mortgages and ATM transactions. The increase in the number of credit cards in circulation contributed to the 85 per cent increase in credit card fee income. Fees from the "Afore" pension funds business continued to perform strongly, with 50 per cent growth and 394,000 new customers. Fee income from international remittances rose by 55 per cent, partly led by the continued success of "La Efectiva", HSBC's electronic remittance card. Monthly transactions exceeded one million, representing a 20 per cent market share and a near seven-fold increase since December 2002. Strong sales of insurance products resulted from increased cross-selling through the branch network and from combining sales with other Personal Financial Services products containing insurance components. Mutual fund balances grew by 58 per cent, partly attributable to the successful launch of new funds targeting different market segments, along with strong cross-sales among HSBC's extensive customer base.

In Brazil, the 52 per cent fall in net fee income was driven by both the inclusion of HSBC's Brazilian insurance business, previously reported in the "Other" business segment, and IFRSs related changes to the reporting of effective interest rates. These decreases were mitigated by higher current account, credit card and lending fees. The recruitment of new customers, particularly through the payroll portfolio, led to a 21 per cent rise in HSBC's current account base which, together with revised tariffs, increased account service fees by 21 per cent. Growth in

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Business Review

(continued)

Latin America > 2005

lending volumes and the introduction of a new pricing structure contributed to a 36 per cent rise in credit-related fee income. Higher credit card spending and additional performance-driven fees from credit card companies generated a 72 per cent increase in credit card fee income. In Argentina, net fee income increased by US\$27 million, reflecting a 29 per cent increase in credit card fees and a 29 per cent increase in current account fee income, driven by increased transaction volumes in a recovering economy.

The sale of HSBC's Brazilian property and casualty insurance business, HSBC Seguros de Automoveis e Bens Limitada, to HDI Seguros S.A. resulted in the recognition of an US\$89 million gain, which was reported in other operating income.

Loan impairment charges and other credit risk provisions increased to US\$600 million, reflecting strong growth in unsecured lending. In Mexico, loan impairment charges rose in line with higher lending volumes and the non-recurrence in 2005 of loan impairment provision releases in 2004, while underlying credit quality remained stable. Credit quality in Brazil remained stable in the majority of product lines, but there was a 5 per cent increase in impaired loans as a proportion of assets in the consumer finance business. The consumer finance sector experienced increased credit availability, which led to indebtedness exceeding customers' repayment capacity and a rise in delinquencies. However, tightening of credit approval policies and enhancements in the credit scoring model resulted in an improvement in the charge as a proportion of assets in the fourth quarter. Credit quality in Argentina improved, reflecting generally better economic conditions.

Operating expenses increased by 25 per cent. In Mexico, they grew by 21 per cent, driven by a combination of higher staff, marketing and IT costs. Staff costs grew by 12 per cent, reflecting increases incurred in improving customer service levels within the branch network, and a rise in bonus costs in line with increased sales. Marketing costs grew to support the credit cards business, evidenced by the 80 per cent increase in the number of cards in circulation. IT costs rose as new systems were rolled out to meet Group standards, such as the WHIRL credit card platform.

In Brazil, the acquisition of Valeu Promotora de Vendas and CrediMatone S.A. led to a significant increase in average staff numbers, though by the end of 2005 staff numbers were 2 per cent lower than at December 2004 following a restructuring of the consumer finance business. The higher average

number of full-time employees, the impact of a mandatory national salary increase and the transfer of the Brazilian insurance business from the "Other" business segment contributed to a 25 per cent increase in Brazilian staff costs. Other expenses grew to support business expansion and the development of direct sales channels, while transactional taxes increased by 21 per cent, driven by higher operating income. In Argentina, costs were 3 per cent up on 2004 as increased performance-related remuneration and union-agreed salary increases led to higher staff costs.

Commercial Banking reported pre-tax profits of US\$357 million, 4 per cent higher than in 2004. In Mexico, excluding the transfer of customers from Personal Financial Services, profit before tax rose due to higher net interest and fee income, partly offset by increased loan impairment charges and cost growth. In Brazil, pre-tax profits increased by 12 per cent as asset growth drove higher revenues, which were mitigated by increased loan impairment charges and higher costs. In Argentina, pre-tax profits declined by 31 per cent, as significant loan recoveries were not repeated.

Net interest income increased by 47 per cent, driven by asset and deposit growth coupled with widening deposit spreads. In Mexico, the transfer of a number of customers from Personal Financial Services increased

both revenues and costs. Net interest income rose by 42 per cent, due in part to a 22 per cent increase in Commercial Banking customers. Deposit balances grew by 38 per cent as a result of expansion into the SME market, while deposit spreads increased by 76 basis points following interest rate rises. Loan balances rose by 21 per cent, principally in the services and commerce sectors, though competitive pricing led to a tightening of lending spreads. The "Estimulo" combined loan and overdraft product, which was launched at the end of 2004, performed strongly, attracting balances of US\$155 million.

In Brazil, a growing economy and a 30 per cent rise in customer numbers led to increases in both assets and liabilities. Overdraft balances grew by 41 per cent as both the number and the average size of facilities grew, contributing US\$40 million of additional income. Overdraft spreads increased by 3 percentage points as a result of increases in the rate charged to new borrowers. The continuing success of *Giro fácil*, a revolving loan and overdraft facility, resulted in a 13 per cent increase in customer numbers which, together with an increase in facility utilisation, resulted in a 77 per cent increase in balances. Invoice financing balances rose by 30 per cent, benefiting from both increased marketing and

[Back to Contents](#)

higher sales to Losango clients, approximately a third of whom now have a commercial banking relationship with HSBC.

Deposit balances in Brazil increased by 21 per cent, reflecting initiatives to incentivise staff to prioritise sales of liability products. However, competitive pressures contributed to a 5 percentage points decrease in spreads on loans and advances to customers, while deposit spreads were 13 basis points lower. In Argentina, deposits from commercial customers increased by 42 per cent, reflecting the continuing economic recovery, while loans and overdrafts more than doubled and current account balances increased by 38 per cent. HSBC increased its market share in both loans and deposits.

Net fee income was 3 per cent higher, led by increases in Mexico and Brazil which were partly offset by IFRSs changes to accounting for effective interest rates which reduced fee income by 22 per cent.

In Mexico, marketing campaigns, tariff reductions and the promotion of business internet banking, together with increased customer numbers, contributed to a 31 per cent increase in payment and cash management fees, while card fees increased following the launch of a credit card as part of the "Estimulo" suite of products. Trade services fee income increased by 63 per cent as a result of customer acquisition and increased cross-sales to existing customers, nearly doubling the bank's market share in a growing market.

In Brazil, the increase was due to higher fees from payments and cash management, current accounts, and lending. Current account fees increased by 26 per cent, reflecting tariff increases, improved collection procedures and higher transaction volumes, while lending fees benefited from higher business volumes. In Argentina, the launch of a commercial banking call centre in the first half of 2005 enhanced the customer service proposition. This, together with the recruitment of additional relationship managers, supported a 14 per cent increase in customer numbers and, as a result, current account fee income increased by 21 per cent. Improvements in the Argentinian economic climate contributed to increased trade flows which, together with the establishment of a dedicated trade service sales team, led to a 22 per cent increase in trade services income.

Loan impairment charges and other credit risk provisions of US\$89 million compared with a net release of US\$23 million in 2004. In Mexico, growth in the lending portfolio led to a US\$49 million increase in loan impairment charges, although underlying credit quality improved.

In Brazil, asset growth contributed to a US\$47 million increase in charges. Impaired loans as a proportion of assets increased by 3 percentage points in the SME portfolio, in line with overall market performance, and MME credit quality also declined slightly. In Argentina, net recoveries decreased as significant releases from amounts recognised at the time of the sovereign debt default and pesification were not repeated. However, underlying credit quality improved substantially and impaired loans as a percentage of assets more than halved.

Operating expenses of US\$621 million were 23 per cent higher than in 2004, though the cost efficiency ratio improved by 3 percentage points as income grew faster than costs. In Mexico, operating expenses increased by 29 per cent, due to an 11 per cent increase in staff numbers to support business growth, higher incentive payments reflecting strong income growth, and increased "Estimulo" marketing expenditure.

Staff numbers in Brazil increased by 34 per cent following a recruitment drive initiated in the second half of 2004 to support expansion of the SME business. Higher incentive payments, reflecting increased income, and union-agreed pay increases also contributed to an increase in staff costs. New marketing campaigns, including the award winning "30, 60, 90 Dias de Apuros" campaign focusing on invoice financing, increased advertising and marketing costs. Expenses in Argentina increased by 24 per cent, driven by higher staff costs, reflecting pay rises agreed with local unions, together with a 9 per cent increase in headcount in support of business expansion.

Corporate, Investment Banking and Markets reported a pre-tax profit of US\$347 million, an increase of 56 per cent, primarily driven by strong growth in net interest income and trading revenues in Mexico.

Total operating income at US\$653 million increased by 28 per cent compared with 2004. In Mexico, net interest income more than doubled, due to the strong performance in balance sheet management, which benefited from higher volumes and successful strategic positioning against a rising short-term interest rate environment, with an overall flattening of the yield curve in the first part of 2005. In the latter half of the year, positions were effectively managed to take advantage of the decline in local rates.

In Argentina, a reduction in funding costs in Global Markets was augmented by the positive impact of an appreciating CER (an inflation-linked

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Business Review

(continued)

Latin America > 2005 / Profit/(loss) before tax

index) on holdings of government bonds. Continuing economic growth and improved market confidence stimulated demand for credit, resulting in a 67 per cent growth in balances. Brazil reported a decrease in balance sheet management and money market revenues as a result of high short-term interest rates and an inverted yield curve.

Net fee income rose by 12 per cent reflecting higher fees in Global Transaction Banking. The payments and cash management business generated higher customer volumes following an extension of the product range and reflected the benefit of improved delivery and distribution channels in Mexico.

Trading activities generated higher income as foreign exchange and derivatives trading were facilitated by the introduction of the Group's standard derivatives system in Mexico. Global Markets in Brazil benefited from a wider product range and the addition of new delivery capabilities. This investment and the relatively buoyant local market resulted in higher business volumes, particularly in foreign exchange. In Argentina, Global Markets income rose in line with increased trading activity in response to the sovereign debt swap.

A US\$11 million net release of loan impairment charges compared favourably with a net charge in 2004. In Brazil, a recovery in the energy sector was accompanied by the non-recurrence of allowances

raised against two specific corporate accounts in 2004.

Operating expenses of US\$273 million were 17 per cent higher than in 2004. In Mexico, operational costs rose in line with higher transactional volumes, while an increase in staff costs partly reflected recruitment to support expansion initiatives. In Brazil, the benefit of a reduction in profit share and bonus payments was partly offset by higher centralised support function staff costs, driven by pay rises agreed with local unions. In Argentina, operating expenses were broadly in line with 2004.

Private Banking reported flat profits. Strong growth in client assets, including US\$2.4 billion of net new money, was driven by growth in Mexico following the launch of Private Banking there in 2004. In Brazil, the business was reorganised in 2005, with the transfer of smaller accounts to Personal Financial Services following a resegmentation of the customer base.

In Brazil, HSBC's insurance business was reclassified from **Other** to Personal Financial Services in 2005. As a result, operating income decreased by US\$106 million and operating expenses fell by US\$90 million. In Argentina, the receipt of compensation bonds and other items related to the pesification in 2002 led to a US\$17 million increase in profit before tax.

[Back to Contents](#)

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

Year ended 31 December 2006

Latin America	Personal Financial Services US\$m	Commercial Banking US\$m	Corporate, Investment Banking & Markets US\$m	Private Banking US\$m	Other US\$m	Inter- segment elimination US\$m	Total US\$m
Net interest income/(expense)	3,057	1,037	325	13	(2)	(233)	4,197
Net fee income	1,053	387	167	23	□	□	1,630
Trading income excluding net interest income	61	21	218	1	□	□	301
Net interest income/(expense) on trading activities	14	5	(16)	□	□	233	236
Net trading income	75	26	202	1	□	233	537
Net income/(expense) from financial instruments designated at fair value	227	□	11	□	(1)	□	237
Gains less losses from financial investments	11	1	72	□	□	□	84
Dividend income	5	1	□	□	□	□	6
Net earned insurance premiums	992	27	59	□	(2)	□	1,076
Other operating income	74	7	10	4	14	(18)	91
Total operating income	5,494	1,486	846	41	9	(18)	7,858
Net insurance claims ¹	(957)	(16)	(51)	□	1	□	(1,023)
Net operating income before loan impairment charges and other credit risk provisions	4,537	1,470	795	41	10	(18)	6,835
Loan impairment (charges)/ recoveries and	(764)	(197)	26	□	(3)	□	(938)

other credit risk
provisions

Net operating income	3,773	1,273	821	41	7	(18)	5,897
Total operating expenses	(2,977)	(822)	(346)	(27)	(12)	18	(4,166)
Operating profit/(loss)	796	451	475	14	(5)	□	1,731
Share of profit in associates and joint ventures	4	□	□	□	□	□	4
Profit/(loss) before tax	800	451	475	14	(5)	□	1,735
	%	%	%	%	%		%

Share of HSBC's profit before tax	3.6	2.0	2.2	0.1	□		7.9
Cost efficiency ratio	65.6	55.9	43.5	65.9	120.0		61.0
	US\$m	US\$m	US\$m	US\$m	US\$m		US\$m

Selected balance sheet data²

Loans and advances to customers (net)	16,165	11,463	8,147	16	□		35,791
Total assets	28,053	16,244	36,333	90	51		80,771
Customer accounts	25,200	13,754	11,685	222	□		50,861

The following assets and liabilities were significant to Corporate, Investment Banking and Markets:

loans and advances to banks (net)			9,704				
trading assets, financial instruments designated at fair value, and financial investments			15,882				
deposits by banks			3,115				

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Business Review

(continued)

Latin America > / Profit/(loss) before tax

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

Year ended 31 December 2005³

	Personal Financial Services US\$m	Commercial Banking US\$m	Corporate, Investment Banking & Markets US\$m	Private Banking US\$m	Other US\$m	Inter- segment elimination US\$m	Total US\$m
Latin America							
Net interest income	2,580	767	292	10	22	(329)	3,342
Net fee income	790	263	122	14	2	□	1,191
Trading income excluding net interest income	56	9	151	3	1	□	220
Net interest expense on trading activities	□	□	(13)	1	□	329	317
Net trading income	56	9	138	4	1	329	537
Net income from financial instruments designated at fair value	174	□	9	□	3	□	186
Gains less losses from financial investments	35	□	10	□	35	□	80
Dividend income	5	□	□	□	□	□	5
Net earned insurance premiums .	794	23	57	□	(3)	□	871
Other operating income/ (expense)	188	18	25	(1)	56	□	286
Total operating income	4,622	1,080	653	27	116	□	6,498
Net insurance claims ¹	(734)	(13)	(45)	□	□	□	(792)
Net operating income before loan impairment charges and other credit risk provisions	3,888	1,067	608	27	116	□	5,706
Loan impairment (charges)/ recoveries and other credit risk provisions	(600)	(89)	11	(2)	4	□	(676)
Net operating income	3,288	978	619	25	120	□	5,030

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Total operating expenses	(2,502)	(621)	(273)	(24)	(6)	□	(3,426)
Operating profit	786	357	346	1	114	□	1,604
Share of profit/(loss) in associates and joint ventures	□	□	1	□	(1)	□	□
Profit before tax	786	357	347	1	113	□	1,604
	%	%	%	%	%		%
Share of HSBC's profit before tax	3.8	1.7	1.7	□	0.5		7.7
Cost efficiency ratio	64.4	58.2	44.9	88.9	5.2		60.0
	US\$m	US\$m	US\$m	US\$m	US\$m		US\$m
Selected balance sheet data ²							
Loans and advances to customers (net)	9,233	6,424	6,012	12	□		21,681
Total assets	15,723	9,491	28,509	53	1,611		55,387
Customer accounts	17,302	4,703	8,661	102	221		30,989

The following assets and liabilities were significant to Corporate, Investment Banking and Markets:

loans and advances to banks							
□ (net)			7,410				
trading assets, financial instruments							
□ designated at fair value, and financial investments			13,067				
□ deposits by banks			1,858				

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[Back to Contents](#)

Year ended 31 December 2004³

	Personal Financial Services US\$m	Commercial Banking US\$m	Corporate, Investment Banking & Markets US\$m	Private Banking US\$m	Other US\$m	Inter- segment elimination US\$m	Total US\$m
Latin America							
Net interest income	1,817	466	217	4	12	□	2,516
Net fee income/(expense)	765	230	95	12	(75)	□	1,027
Trading income/(expense)	35	12	81	□	(1)	□	127
Net investment income on assets backing policyholders' liabilities	40	1	9	□	45	□	95
Gains less losses from financial investments	8	5	(1)	□	35	□	47
Dividend income	□	□	□	□	2	□	2
Net earned insurance premiums	251	34	55	□	359	□	699
Other operating income	25	18	6	1	12	(16)	46
Total operating income	2,941	766	462	17	389	(16)	4,559
Net insurance claims ¹	(219)	(25)	(47)	□	(244)	□	(535)
Net operating income before loan impairment charges and other credit risk provisions	2,722	741	415	17	145	(16)	4,024
Loan impairment (charges)/ recoveries and other credit risk provisions	(270)	23	(7)	□	1	□	(253)
Net operating income	2,452	764	408	17	146	(16)	3,771
Total operating expenses	(1,801)	(448)	(212)	(17)	(68)	16	(2,530)
Operating profit	651	316	196	□	78	□	1,241
Share of profit in associates and joint ventures	□	□	□	□	1	□	1
Profit before tax	651	316	196	□	79	□	1,242
	%	%	%	%	%		%
Share of HSBC's profit before tax	3.4	1.7	1.0	□	0.4		6.5
Cost efficiency ratio	66.2	60.5	51.1	100.0	46.9		62.9
	US\$m	US\$m	US\$m	US\$m	US\$m		US\$m
Selected balance sheet data²							
Loans and advances to customers (net)	9,709	3,021	2,622	2	339		15,693
Total assets	16,973	5,027	17,014	34	1,371		40,419
Customer accounts	13,642	6,284	6,259	11	111		26,307

The following assets and liabilities were significant to Corporate, Investment Banking and Markets:

□ loans and advances to banks (net)	5,046
□ trading assets, financial instruments designated at fair value, and financial investments	7,860
□ deposits by banks	1,825

- 1 *Net insurance claims incurred and movement in policyholders' liabilities.*
- 2 *Third party only.*
- 3 *In 2006, Mexico and Panama were reclassified from the North America segment to Latin America. Comparative information has been restated accordingly.*

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Business Review

(continued)

Products and services

Other information

Products and services

Personal Financial Services

Personal Financial Services provides over 120 million individual and self-employed customers with a wide range of banking and related financial services. The precise nature of the products and services provided is, to some extent, driven by local regulations, market practices and the positioning of HSBC's local businesses. Typically, products provided include current and savings accounts, mortgages and personal loans, credit cards, and local and international payment services.

HSBC uses its global reach to offer tailored financial services to customers banking in more than one country.

Personal customers prefer to conduct their financial business at times convenient to them, using a range of delivery channels. This demand for flexibility is met through the increased provision of direct channels such as the internet and self-service terminals, in addition to traditional and automated branches and service centres accessed by telephone.

Delivering the right products and services for particular target markets is a fundamental requirement in any retail service business, and market research and customer analysis is key to developing an in-depth understanding of significant customer segments and their needs. This understanding of the customer ensures that customer relationship management systems are effectively used to identify and fulfil sales opportunities, and to manage the sales process.

HSBC *Premier* is a premium banking service providing personalised relationship management, 24-hour priority telephone access, global travel assistance and cheque encashment facilities. There are now over 1.8 million HSBC *Premier* customers, who can use more than 250 specially designated *Premier* branches and centres in 36 countries and territories, either temporarily when visiting or on a more permanent basis if they require a banking relationship in more than one country.

HSBC Finance's operations in the US, the UK and Canada make credit available to customers not well catered for by traditional banking operations, facilitate point-of-sale credit in support of retail purchases and support major affiliate credit card programmes. At 31 December 2006, HSBC Finance had over 66 million customers with total gross advances of US\$217.3 billion.

HSBC Finance serves personal customers through the following business units:

- The **consumer lending** business unit is one of the largest sub-prime home equity originators in the US, marketed under the HFC and Beneficial brand names. Consumer lending also acquires sub-prime loans on the secondary market.
- The **mortgage services** business unit purchases first and second lien mortgage loans, including open-end home equity loans, from a network of over 220 unaffiliated third-party lenders in the US. Decision One Mortgage Company, a subsidiary of HSBC Finance, originates mortgage loans sourced by mortgage brokers and sells all loans to secondary market purchasers, including HSBC's mortgage services business.

- The **retail services** business unit is one of the largest providers of third party private label credit cards (or store cards) in the US based on receivables outstanding, with over 66 merchant relationships and 16.6 million active customer accounts.
- In addition to originating and refinancing motor vehicle loans, HSBC Finance's **motor vehicle finance** business unit purchases retail instalment contracts of US customers who do not have access to traditional prime-based lending sources. The loans are largely sourced from a network of approximately 9,500 motor dealers.
- The **credit card services** business unit is the fifth largest issuer of MasterCard and Visa credit cards in the US, and includes affiliation programmes such as the GM Card, the AFL- CIO Union Plus credit card, the Household Bank, Orchard Bank and, HSBC branded cards, and the Direct Merchants Bank MasterCard. Credit card services also cross-sell to customers in the consumer lending, motor vehicle finance, retail services and taxpayer financial services businesses.
- The **taxpayer financial services** business unit accelerates access to funds for US taxpayers who are entitled to tax refunds. The business is seasonal with most revenues generated in the first three months of the year.
HSBC Finance's business in the UK, HFCBank, provides mid-market consumers with mortgages, secured and unsecured loans, retail finance and insurance products. In Canada, similar products are offered through trust operations of HSBC Finance's subsidiary there.

[Back to Contents](#)

Insurance and investment products play an important part in meeting the needs of customers. Insurance products distributed by HSBC through its direct channels and branch networks include loan protection, life, property and health insurance and pensions. Acting as both broker and underwriter, HSBC sees continuing opportunities to deliver insurance products to its customer base.

HSBC also makes available a wide range of investment products. A choice of third party and proprietary funds is offered, including traditional "long only" equity and bond funds; structured funds that provide capital security and opportunities for an enhanced return; and "fund of funds" products which offer customers the ability to diversify their investments across a range of best-in-class fund managers chosen after a rigorous and objective selection process. Comprehensive financial planning services covering customers' investment, retirement, personal and asset protection needs are offered through specialist financial planning managers.

High net worth individuals and their families who choose the differentiated services offered within Private Banking are not included in this customer group.

Commercial Banking

HSBC is one of the world's leading, and most international, banks, with 2.6 million Commercial Banking customers in 62 locations, including sole proprietors, partnerships, clubs and associations, incorporated businesses and publicly quoted companies. At 31 December 2006, HSBC had total commercial customer account balances of US\$191 billion and total commercial customer loans and advances, net of loan impairment allowances, of US\$173 billion.

HSBC segments its Commercial Banking business into corporate, medium, small and micro business, allowing the development of tailored customer propositions whilst adopting a broader view of the entire Commercial Banking sector, from sole traders to top end mid-market corporations. This allows HSBC to provide continuous support to companies as they grow in size both domestically and internationally, and ensures a clear focus on the small and micro business sectors, which are typically the key to innovation and growth in market economies.

HSBC places particular emphasis on geographical collaboration to meet its business customers' needs and aims to be recognised as the leading international business bank and the best bank

for small business in target markets. The range of products and services includes:

Financing : HSBC provides a range of short and longer-term financing options for Commercial Banking customers, both domestically and cross-border, including overdrafts, receivables finance, term loans and property finance. HSBC offers forms of asset finance in five sites and has established specialised divisions providing leasing and instalment finance for vehicles, plant and equipment.

Payments and cash management: HSBC is a leading provider of domestic and cross-border payments, collections, liquidity management and account services worldwide. HSBC's extensive network of offices and direct access to numerous local clearing systems, enhances its customers' ability to manage their cash efficiently on a global basis.

International trade: HSBC finances and facilitates significant volumes of international trade, under both open account terms and traditional trade finance instruments. HSBC also provides international factoring, commodity and insured export finance, and forfaiting services. HSBC utilises its extensive international network to build customer relationships at both ends of trade flows, and maximises efficiency through expertise in documentary checking and processing, and highly automated systems.

Treasury and capital markets: Commercial Banking customers are volume users of the Group's foreign exchange capabilities, including sophisticated currency and interest rate options.

Commercial cards: HSBC offers commercial card services in 16 countries. Commercial card issuing provides its customers with services which enhance cash management, improve cost control and streamline

purchasing processes. HSBC offers card acquiring services, either directly or as part of a joint venture, enabling merchants to accept credit card payments either in store or on the internet.

Insurance: HSBC offers insurance services in 25 sites, which cover a full range of commercial insurance products designed to meet the needs of businesses and their employees, including employee benefit, pension and healthcare programmes. These products are provided by HSBC either as an intermediary (broker, agent or consultant) or as a supplier of in-house or third party offerings. HSBC also provides insurance due diligence reviews, and actuarial and employee benefit consultancy services.

Wealth management services: These include advice and products related to savings and

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Business Review

(continued)

Products and services / Property / Legal proceedings

investments provided to Commercial Banking customers and their employees through HSBC's worldwide network, with clients being referred to Private Banking where appropriate.

Investment banking: A small number of Commercial Banking customers need corporate finance and advisory support. These requirements are serviced by the Group on a client-specific basis.

Delivery channels: HSBC deploys a full range of delivery channels, including specific online and direct banking offerings such as HSBCnet and Business Internet Banking.

Corporate, Investment Banking and Markets

HSBC's Corporate, Investment Banking and Markets business provides tailored financial solutions to major government, corporate and institutional clients worldwide. Managed as a global business, this customer group operates a long-term relationship management approach to build a full understanding of clients' financial requirements. Sectoral client service teams comprising relationship managers and product specialists develop financial solutions to meet individual client needs. With dedicated offices in over 60 countries and access to HSBC's worldwide presence and capabilities, this business serves subsidiaries and offices of its clients on a global basis.

Corporate, Investment Banking and Markets is managed as three principal business lines: Global Markets, Global Banking and Group Investment Businesses. This structure allows HSBC to focus on relationships and sectors that best fit the Group's footprint and facilitates seamless delivery of HSBC's products and services to clients.

Products and services offered include:

Global Markets

HSBC's operations in Global Markets consist of treasury and capital markets services for supranationals, central banks, corporations, institutional and private investors, financial institutions and other market participants.

Products include:

- foreign exchange;
- currency, interest rate, bond, credit, equity and other specialised derivatives;
- government and non-government fixed income and money market instruments;
- precious metals and exchange traded futures;
- equity services, including research, sales and trading for institutional, corporate and private clients and asset management services;
- distribution of capital markets instruments, including debt, equity and structured products, utilising links with HSBC's global networks and

- securities services, where HSBC is one of the world's leading custodians providing custody and clearing services and funds administration to both domestic and cross-border investors.

Global Banking

HSBC's operations in Global Banking consist of financing, advisory and transaction services for corporations, institutional and private investors, financial institutions, and governments and their agencies. Products include:

- investment banking, which comprises capital raising, including debt and equity capital, and corporate finance and advisory services;
- lending, comprising bilateral and syndicated lending, leveraged and acquisition finance, structured and project finance; lease finance; and non-retail deposit-taking;
- international, regional and domestic payments and cash management services; and
- other transaction services, including trade services, factoring and banknotes.

Group Investment Businesses

These comprise asset management products and services for institutional investors, intermediaries and individual investors and their advisers.

Other

Other products include private equity, which comprises HSBC's captive private equity funds, strategic relationships with third party private equity managers and other investments.

Private Banking

HSBC's presence in all the major wealth-creating regions has enabled it to build one of the world's leading private banking groups, providing financial services to high net worth individuals and their families from 90 locations in 35 countries and territories, with client assets of US\$333 billion at 31 December 2006.

HSBC Private Bank is the principal marketing name of the HSBC Group's international private banking business which, together with HSBC

[Back to Contents](#)

Guyertzeller and HSBC Trinkaus & Burkhardt, provides the services noted below.

Utilising the most suitable products from the marketplace, Private Banking works with its clients to offer both traditional and innovative ways to manage and preserve wealth while optimising returns. Products and services offered include:

Investment services: These comprise both advisory and discretionary investment services. A wide range of investment vehicles is covered, including bonds, equities, derivatives, options, futures, structured products, mutual funds and alternative products, such as hedge funds and fund of funds. By accessing regional expertise located within six major advisory centres in Hong Kong, Singapore, Geneva, New York, Paris and London, Private Banking seeks to select the most suitable investments for clients' needs and investment strategies.

Global wealth solutions: These comprise inheritance planning, trustee and other fiduciary services designed to protect existing wealth and create tailored structures to preserve wealth for future generations. Areas of expertise include trusts, foundation and company administration, charitable trusts and foundations, insurance and offshore structures.

Specialist advisory services: Private Banking offers expertise in several specialist areas of wealth management including tax advisory and financial planning, family office advisory, corporate finance, consolidated reporting, industry services such as charities and foundations, media, shipping, diamond and jewellery, and real estate planning. Specialist advisers are available to deliver products and services that are tailored to meet the full range of high net worth clients' individual financial needs.

General banking services: These comprise treasury and foreign exchange, offshore and onshore deposits, credit and specialised lending, tailor-made loans and internet banking. Private Banking works to ensure its clients have full access to relevant skills and products available throughout HSBC, such as corporate banking, investment banking and insurance.

Property

At 31 December 2006, HSBC operated from some 10,200 operational properties worldwide, of which approximately 3,200 were located in Europe, 700 in Hong Kong and the Rest of Asia-Pacific, 2,300 in North America and 4,000 in Latin America (including 1,550 in Mexico). These properties had an

area of approximately 65.4 million square feet (2005: 63.8 million square feet).

Freehold, long leasehold and short leasehold land and buildings carried on the balance sheet represented 40 per cent of HSBC's operational space. In addition, properties with a net book value of US\$1,949 million were held for investment purposes. Of the total net book value of HSBC properties, more than 78% per cent were owned or held under long-term leases.

HSBC's properties are stated at cost, being historical cost or fair value at the date of transition to IFRSs (their deemed cost) less any impairment losses, and are depreciated on a basis calculated to write off the assets over their estimated useful lives. Properties owned as a consequence of an acquisition are recognised initially at fair value.

Valuation of freehold and leasehold land and buildings

HSBC's freehold and long leasehold properties, together with all leasehold properties in Hong Kong, were valued in 2006. The value of these properties was US\$1.7 billion in excess of their carrying amount in the consolidated balance sheet.

Further details are included in Note 23 on the Financial Statements on page 366.

Legal proceedings

HSBC is party to legal actions in a number of jurisdictions including the UK, Hong Kong and the US, arising out of its normal business operations. HSBC considers that none of the actions is regarded as material, and none is expected to result in a significant adverse effect on the financial position of HSBC, either individually or in the aggregate. Management believes that adequate provisions have been made in respect of such litigation. HSBC has not disclosed any contingent liability associated with these legal actions because it is not practicable to do so.

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Financial Review*Introduction / Critical accounting policies*

	<i>Page</i>
<u>Introduction</u>	<u>110</u>
<u>Critical accounting policies</u>	<u>111</u>
<u>Key performance indicators</u>	<u>115</u>
<u>Financial summary</u>	<u>119</u>
<u>Income statement</u>	<u>119</u>
<u>Net interest income</u>	<u>122</u>
<u>Net fee income</u>	<u>125</u>
<u>Net trading income</u>	<u>128</u>
<u>Net income from financial instruments designated at fair value</u>	<u>129</u>
<u>Gains less losses from financial investments</u>	<u>131</u>
<u>Net earned insurance premiums</u>	<u>132</u>
<u>Other operating income</u>	<u>133</u>
<u>Net insurance claims incurred and movement in policyholders' liabilities</u>	<u>135</u>
<u>Loan impairment charges and other credit risk provisions</u>	<u>136</u>
<u>Operating expenses</u>	<u>139</u>
<u>Share of profit in associates and joint ventures</u>	<u>142</u>
<u>Asset deployment</u>	<u>144</u>
<u>Trading assets and financial investments</u>	<u>144</u>
<u>Funds under management</u>	<u>145</u>
<u>Assets in custody and under administration</u>	<u>145</u>
<u>Economic profit</u>	<u>146</u>
<u>Other financial information</u>	<u>147</u>
<u>Average balance sheet and net interest income</u>	<u>147</u>
<u>Analysis of changes in net interest income</u>	<u>154</u>
<u>Share capital and reserves</u>	<u>157</u>
<u>Short-term borrowings</u>	<u>158</u>
<u>Contractual obligations</u>	<u>158</u>
<u>Loan maturity and interest sensitivity analysis</u>	<u>159</u>
<u>Deposits</u>	<u>160</u>
<u>Certificates of deposit and other time deposits</u>	<u>162</u>
<u>Off-balance sheet arrangements</u>	<u>163</u>
<u>Disclosure controls</u>	<u>164</u>
<u>Management's assessment of internal controls</u>	<u>164</u>

Introduction

The consolidated financial statements of HSBC and the separate financial statements of HSBC Holdings have been prepared in accordance with International Financial Reporting Standards (IFRSs) as endorsed by the European Union (EU). EU-endorsed IFRSs may differ temporarily from IFRSs as published by the International Accounting Standards Board (IASB) if, at any point in time, new or amended IFRSs have not been endorsed by the EU. At 31 December 2006, there were no unendorsed standards, effective for the year ended 31 December 2006, affecting these consolidated and separate financial statements, and there was no difference in application to HSBC between IFRSs endorsed by the EU and IFRSs issued by the IASB.

Certain information for years prior to 2004 has been prepared under UK Generally Accepted Accounting Principles (UK GAAP), which are not comparable with IFRSs.

HSBC uses the US dollar as its presentation currency because the US dollar and currencies linked to it form the major currency bloc in which HSBC transacts its business. Unless otherwise stated, the accounting

information presented in this document has been prepared in accordance with IFRSs.

IFRSs compared with US GAAP

	2006	2005	2004
	US\$m	US\$m	US\$m
Net income			
US GAAP	16,358	14,703	12,506
IFRSs	15,789	15,081	12,918
Shareholders' equity			
US GAAP	108,540	93,524	90,082
IFRSs	108,352	92,432	85,522

HSBC provides details of its net income and shareholders' equity calculated in accordance with US GAAP, which differs in certain respects from IFRSs. Differences in net income and shareholders' equity are explained in Note 47 on the Financial Statements on pages 403 to 434.

Constant currency

Constant currency comparatives in respect of 2005 and 2004 used in the 2006 and 2005 commentaries respectively are computed by retranslating into US dollars:

- the income statements for 2005 and 2004 of non-US dollar branches, subsidiaries, joint ventures and associates at the average rates of exchange for 2006 and 2005 respectively; and

[Back to Contents](#)

- the balance sheets at 31 December 2005 and 2004 for non-US dollar branches, subsidiaries, joint ventures and associates at the prevailing rates of exchange on 31 December 2006 and 2005 respectively.
No adjustments are made to the exchange rates used to translate assets and liabilities denominated in foreign currencies into the functional currencies of any HSBC branch, subsidiary, joint venture or associate.

	2006 compared with 2005		2005 compared with 2004	
	As reported	Constant currency on an underlying basis	As reported	Constant currency on an underlying basis
	%	%	%	%
Operating income and cost growth				
Total operating income	14	11	10	10
Net operating income before loan impairment charges and other credit risk provisions	13	11	12	12
Total operating expenses	14	11	11	9

Comparison of financial information

When reference is made to "constant currency" or "constant exchange rates" in 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 in respect of the income statement or the balance sheet. When reference to "underlying basis" is made, comparative information has been expressed at constant currency and adjusted for the effect of acquisitions, disposals, and the change in presentation of non-equity minority issues affecting the 2005 comparison with 2004.

As the transition to IFRSs affected the comparability of the financial information presented in this document (see Note 1 on the Financial Statements), the commentaries that follow specify the impact when this is material to a reader's understanding of the underlying business trends.

Critical accounting policies*(Audited)***Introduction**

The results of HSBC are sensitive to the accounting policies, assumptions and estimates that underlie the preparation of its consolidated financial statements. The accounting policies used in the preparation of the consolidated financial statements are described in detail in Note 2 on the Financial Statements.

When preparing the financial statements, it is the directors' responsibility under UK company law to select suitable accounting policies and to make judgements and estimates that are reasonable and prudent.

The accounting policies that are deemed critical to HSBC's IFRSs results and financial position, in terms of the materiality of the items to which the

policy is applied, and which involve a high degree of judgement and estimation, are discussed below.

Impairment of loans

HSBC's accounting policy for losses arising from the impairment of customer loans and advances is described in Note 2(f) on the Financial Statements.

Losses in respect of impaired loans are reported in HSBC's income statement under the caption "Loan impairment charges and other credit risk provisions". An increase in these losses has the effect of reducing HSBC's profit for the period by a corresponding amount (while a decrease in impairment charges or reversal of impairment charges has the opposite effect).

Losses for impaired loans are recognised promptly when there is objective evidence that impairment of a loan or portfolio of loans has occurred. Impairment losses are calculated on individual loans and on loans assessed collectively. Losses expected from future events, no matter how likely, are not recognised.

Individually assessed loans

At each balance sheet date, HSBC assesses on a case-by-case basis whether there is any objective evidence that a loan is impaired. This procedure is applied to all accounts that are considered individually significant. In determining impairment losses on these loans, the following factors are considered:

- HSBC's aggregate exposure to the customer;
- the viability of the customer's business model and their capacity to trade successfully out of financial difficulties and generate sufficient cash flow to service debt obligations;

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Financial Review

(continued)

Critical accounting policies

- the amount and timing of expected receipts and recoveries;
 - the likely dividend available on liquidation or bankruptcy;
 - the extent of other creditors' commitments ranking ahead of, or *pari passu* with, HSBC and the likelihood of other creditors continuing to support the company;
 - the complexity of determining the aggregate amount and ranking of all creditor claims and the extent to which legal and insurance uncertainties are evident;
 - the realisable value of security (or other credit mitigants) and likelihood of successful repossession;
 - the likely deduction of any costs involved in recovery of amounts outstanding;
 - the ability of the borrower to obtain, and make payments in, the currency of the loan if not denominated in local currency; and
 - when available, the secondary market price of the debt.
- Impairment losses are calculated by discounting the expected future cash flows of a loan at its original effective interest rate, and comparing the resultant present value with the loan's current carrying amount.

The carrying amount of impaired loans on the balance sheet is reduced through the use of an allowance account. HSBC's policy requires a review of the level of impairment allowances on individual facilities above materiality thresholds at least half-yearly, or more regularly when individual circumstances require. This normally includes a review of collateral held (including re-confirmation of its enforceability) and an assessment of actual and anticipated receipts.

Collectively assessed loans

Impairment is assessed on a collective basis in two circumstances:

- to cover losses which have been incurred but have not yet been identified on loans subject to individual assessment; and
 - for homogeneous groups of loans that are not considered individually significant.
- Incurred but not yet identified impairment

Individually assessed loans for which no evidence of loss has been specifically identified on an individual

basis are grouped together according to their credit risk characteristics for the purpose of calculating an estimated collective loss. This reflects impairment losses incurred at the balance sheet date which will only be individually identified in the future.

The collective impairment allowance is determined after taking into account:

- historical loss experience in portfolios of similar credit risk characteristics (for example, by industry sector, loan grade or product);

- the estimated period between impairment occurring and the loss being identified and evidenced by the establishment of an appropriate allowance against the individual loan; and
- management's experienced judgement as to whether current economic and credit conditions are such that the actual level of inherent losses is likely to be greater or less than that suggested by historical experience.

The period between a loss occurring and its identification is estimated by local management for each identified portfolio.

Homogeneous groups of loans

For homogeneous groups of loans that are not considered individually significant, two alternative methods are used to calculate allowances on a portfolio basis:

When appropriate empirical information is available, HSBC utilises roll-rate methodology. This methodology employs statistical analysis of historical trends of delinquency and default to estimate the likelihood that loans will progress through the various stages of delinquency and ultimately prove irrecoverable. The estimated loss is the difference between the present value of expected future cash flows, discounted at the original effective interest rate of the portfolio, and the carrying amount of the portfolio. Current economic conditions are also evaluated when calculating the appropriate level of allowance required to cover inherent loss. In certain highly developed markets, sophisticated models also take into account behavioural and account management trends as revealed in, for example, bankruptcy and rescheduling statistics.

In other cases, when the portfolio size is small or when information is insufficient or not reliable enough to adopt a roll-rate methodology, HSBC adopts a formulaic approach which allocates progressively higher percentage loss rates the longer a customer's loan is overdue. Loss rates are

[Back to Contents](#)

calculated from the discounted expected future cash flows from a portfolio.

In normal circumstances, historical experience provides the most objective and relevant information from which to assess inherent loss within each portfolio. In certain circumstances, historical loss experience provides less relevant information about the inherent loss in a given portfolio at the balance sheet date, for example, where there have been changes in economic, regulatory or behavioural conditions such that the most recent trends in the portfolio risk factors are not fully reflected in the statistical models. In these circumstances, such risk factors are taken into account when calculating the appropriate level of impairment allowances, by adjusting the impairment allowances derived solely from historical loss experience. Key risk factors include recent trends in charge-off and delinquency, economic conditions such as national and local trends in housing markets, changes in product mix and concentration, bankruptcy trends, other market conditions such as changes in interest rates and energy prices, changes in laws and regulations and natural disasters.

Roll rates, loss rates and the expected timing of future recoveries are regularly benchmarked against actual outcomes to ensure they remain appropriate.

The portfolio approach is generally applied to the following types of portfolios:

- low value, homogeneous small business accounts in certain jurisdictions;
- residential mortgages;
- credit cards and other unsecured consumer lending products; and
- motor vehicle financing.

These portfolio allowances are generally reassessed monthly and charges for new allowances, or reversals of existing allowances, are calculated for each separately identified portfolio.

Loan write-offs

Loans (and the related impairment allowance accounts) are normally written off, either partially or in full, when there is no realistic prospect of recovery of these amounts and when the proceeds from realising security have been received.

Reversals of impairment

If the amount of an impairment loss decreases in a subsequent period, and the decrease can be related

objectively to an event occurring after the impairment was recognised, the excess is written back by reducing the loan impairment allowance account accordingly. The reversal is recognised in the income statement.

Assets acquired in exchange for loans

Non-financial assets acquired in exchange for loans as part of an orderly realisation are recorded as assets held for sale and reported in "Other assets". The asset acquired is recorded at the lower of its fair value (less costs to sell) and the carrying amount of the loan (net of impairment allowance) at the date of exchange. No depreciation is charged in respect of assets held for sale. Any subsequent write-down of the acquired asset to fair value less costs to sell is recognised in the income statement in "Other operating income". Any subsequent increase in the fair value less costs to sell, to the extent this does not exceed the cumulative write down, is also recognised in "Other operating income", together with any realised gains or losses on disposal.

Renegotiated loans

The impairment of personal loans is generally subject to collective assessment. Personal loans whose terms have been renegotiated are no longer considered past due, but are treated as new loans only after a minimum required number of payments required under the new arrangements have been received.

Loans subject to individual impairment assessment whose terms have been renegotiated are subject to ongoing review to determine whether they remain impaired or should be considered past due.

Further information on impairment assessment and impairment allowances is set out on pages 174 to 176.

Goodwill impairment

HSBC's accounting policy for goodwill is described in Note 2(o) on the Financial Statements.

Goodwill arises on business combinations, including the acquisition of subsidiaries, and interests in joint ventures and associates, when the cost of acquisition exceeds the fair value of HSBC's share of the identifiable assets, liabilities and contingent liabilities acquired. By contrast, if HSBC's interest in the fair value of the identifiable assets, liabilities and contingent liabilities of an

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Financial Review

(continued)

Critical accounting policies / Key performance indicators

acquired business is greater than the cost of acquisition, the excess is recognised immediately in the income statement.

Goodwill is allocated to cash-generating units (CGU) for the purpose of impairment testing, which is undertaken at the lowest level at which goodwill is monitored for internal management purposes. Impairment testing is performed at least annually by comparing the present value of the expected future cash flows from a business with the carrying amount of its net assets, including attributable goodwill.

Significant management judgement is involved in two aspects of the process of identifying and evaluating goodwill impairment.

First, the cost of capital assigned to an individual CGU and used to discount its future cash flows can have a significant effect on the CGU's valuation. The cost of capital percentage is generally derived from a Capital Asset Pricing Model, which itself depends on inputs reflecting a number of financial and economic variables including the risk-free interest rate in the country concerned and a premium to reflect the inherent risk of the business being evaluated. These variables are established on the basis of management judgement.

Second, management judgement is required in estimating the future cash flows of the CGU. These values are sensitive to the cash flows projected for the periods for which detailed forecasts are available, and to assumptions regarding the long-term pattern of sustainable cash flows thereafter. While the acceptable range within which underlying assumptions can be applied is governed by the requirement to compare resulting forecasts with actual performance and verifiable economic data in future years, the cash flow forecasts necessarily and appropriately reflect management's view of future business prospects.

When this exercise demonstrates that the expected cash flows of a CGU have declined and/or that its cost of capital has increased, the effect is to reduce the CGU's estimated fair value. If this results in an estimated recoverable amount that is lower than the carrying value of the CGU, a charge for impairment of goodwill will be recorded, thereby reducing by a corresponding amount HSBC's profit for the year. Goodwill is stated at cost less accumulated impairment losses.

Goodwill on acquisitions of interests in joint ventures or associates is included in Interests in associates and joint ventures.

At the date of disposal of a business, attributable goodwill is included in HSBC's share of net assets in the calculation of the gain or loss on disposal.

Valuation of financial instruments

HSBC's accounting policy for valuation of financial instruments is described in Note 2(d) on the Financial Statements.

All financial instruments are recognised initially at fair value. The fair value of a financial instrument on initial recognition is normally the transaction price, i.e. the fair value of the consideration given or received. In certain circumstances, however, the initial fair value may be based on other observable current market transactions in the same instrument, without modification or repackaging, or on a valuation technique whose variables include

only data from observable markets.

Subsequent to initial recognition, the fair values of financial instruments measured at fair value that are quoted in active markets are based on bid prices for assets held and offer prices for liabilities. When independent prices are not available, fair values are determined by using valuation techniques which refer to observable market data. These include comparisons with similar financial instruments for which market observable prices exist, discounted cash flow analyses, option pricing models and other valuation techniques commonly used by market participants.

The main factors which management considers when applying a model are:

- the likelihood and expected timing of future cash flows on the instrument. These cash flows are usually governed by the terms of the instrument, although management judgement may be required when the ability of the counterparty to service the instrument in accordance with the contractual terms is in doubt; and
- an appropriate discount rate for the instrument. Management determines this rate, based on its assessment of the appropriate spread of the rate for the instrument over the risk-free rate.

When valuing instruments by reference to comparable instruments, management takes into account the maturity, structure and rating of the instrument with which the position held is being compared. When valuing instruments on a model basis using the fair value of underlying components, management considers, in addition, the need for adjustments to take account of factors such as bid-offer spread, credit profile and model uncertainty.

[Back to Contents](#)

These adjustments are based on defined policies which are applied consistently across HSBC.

When unobservable market data have a significant impact on the valuation of derivatives, the entire initial difference in fair value indicated by the valuation model from the transaction price is not recognised immediately in the income statement but is recognised over the life of the transaction on an appropriate basis or is recognised in the income statement when the inputs become observable, or when the transaction matures or is closed out.

Financial instruments measured at fair value through profit or loss comprise financial instruments held for trading and financial instruments designated at fair value. Changes in their fair value directly impact HSBC's income statement in the period in which they occur.

A change in the fair value of a financial asset which is classified as "available-for-sale" is recorded directly in equity until the financial asset is sold, at which point the cumulative change in fair value is charged or credited to the income statement. When a decline in the fair value of an available-for-sale financial asset has been recognised directly in equity and there is objective evidence that the asset is impaired, the cumulative loss that had been recognised directly in equity is removed from equity and recognised in profit or loss, reducing HSBC's operating profit.

In Notes on the Financial Statements, Note 15 includes a table which summarises HSBC's trading portfolio by valuation methodology, and Note 33 provides an analysis of the fair value of financial instruments not measured at fair value in the balance sheet.

Key performance indicators

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

As a prerequisite for the vesting of performance shares, the Remuneration Committee must satisfy itself that HSBC's financial performance has shown a sustained improvement in the period since the award date. In determining this, the Remuneration Committee takes into account HSBC's financial performance with regard to the financial key performance indicators ("KPIs") described below. For awards made since 2005, the KPIs are compared with the same group of 28 comparator banks as for the TSR performance condition.

Financial KPIs

HSBC's strategic plan, "Managing for Growth", provides HSBC with a blueprint for organic growth and development. This began in 2003 and will continue up to 2008. The plan is aimed at guiding the Group to achieve management's vision for HSBC to be the world's leading financial services company.

To support the Group's strategy and ensure that HSBC's performance can be monitored, management utilises a number of financial KPIs. The table below presents these KPIs for the period from 2004 to 2006. At a business level, the KPIs are complemented by a range of benchmarks which are relevant to the planning process and to reviewing business performance.

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Financial Review

(continued)

*Key performance indicators***Financial KPIs used by HSBC's management**

	2006 %	2005 %	2004 ¹⁰ %
Revenue growth ¹	13.4	12.2	□
Revenue mix ²			
Net interest income	52.8	54.4	60.6
Net fee income	26.3	25.1	25.2
Other income ³	20.9	20.5	14.2
Cost efficiency ⁴	51.3	51.2	51.6
Credit performance as measured by risk adjusted margin ⁵	6.3	6.3	6.8
Return on average invested capital ⁶	14.9	15.9	15.0
Dividend performance ⁷	10.1	9.5	5.0
Earnings per share ⁸ (US\$)	1.40	1.36	1.18
	Over 1 year	Over 3 years	Over 5 years
Total shareholder return⁹			
HSBC TSR	104.6	122.0	148.4
Benchmarks:			
□ FTSE 100	114.4	153.8	141.1
□ MSCI World	105.8	139.9	122.4

1 *The percentage increase in net operating income before loan impairment and other credit risk charges since the previous reporting period.*

2 *As a percentage of net operating income before loan impairment charges and other credit risk provisions.*

3 *Other income comprises net operating income before loan impairment charges and other credit risk provisions less net interest income and net fee income.*

4 *Total operating expenses divided by net operating income before loan impairment and other credit risk charges.*

5 *Net operating income divided by average risk-weighted assets.*

6 *Profit attributable to ordinary shareholders divided by average invested capital.*

7 *The percentage increase in dividend per share since the previous reporting period.*

8 *Basic earnings per share is defined in note 12.*

9 *Total shareholder return is defined on page 281.*

10 *Presentational changes introduced under IFRSs on 1 January 2005 distort comparison of 2004 data with succeeding years.*

Revenue growth provides an important guide to the Group's success in generating business. In 2006, total revenue grew by 13.4 per cent to US\$65.4 billion, 10.5 per cent on an underlying basis, reflecting HSBC's expansion into new products and markets, improved brand recognition and refinements in segmentation to better meet customer needs. The trend maintained the strong performance in 2005 when the underlying increase was 11.7 per cent. Higher revenue was largely driven by balance sheet growth and strong contributions from emerging markets, where HSBC continued to introduce products and services developed in mature economies to these faster growing regions.

Revenue mix represents the relative distribution of revenue streams between net interest income, net fee income and other revenue. It is used to understand how changing economic factors affect

the Group, to highlight dependence on balance sheet utilisation for income generation and to indicate success in cross-selling fee-based services to customers with loan facilities. This understanding assists management in making business investment decisions. Comparison of the revenue mix since 2004 indicates that it has been broadly stable over recent years. The percentage of revenue attributable to net interest income fell, however, from 54.4 per cent in 2005 to 52.8 per cent in 2006 as balance sheet management revenues were constrained by an adverse interest rate environment while fee and trading-based revenue streams have grown more strongly.

Cost efficiency is a relative measure that indicates the consumption of resources in generating revenue. Management uses this metric to assess the success of technology utilisation and, more generally, the productivity of the Group's distribution platforms and sales forces. The cost efficiency ratio for 2006 was broadly in line with the previous two years notwithstanding ongoing investment in HSBC's businesses, particularly in emerging markets, and in improving the Group's distribution and technology platforms.

Credit performance as measured by risk-adjusted margin is an essential gauge for assessing whether credit is correctly priced so that the returns available after recognising impairment charges meet the Group's required return parameters. The ratio for 2006 was 6.3 per cent, unchanged from 2005, showing a trend to higher-margin earnings relative to risk, notwithstanding the significant credit losses in the mortgage services business in the US described on page 189. Management aims to improve risk-adjusted performance over time.

Return on average invested capital measures the return on the capital investment made in the business, enabling management to benchmark HSBC against competitors. In 2006, the ratio of 14.9 per cent was 100 basis points lower than that reported in 2005. This decline reflected the fact that profitability grew more slowly than the capital utilised in generating the profit because of the higher impairment charges recognised in 2006, largely in respect of the mortgage services business in the US.

HSBC aims to deliver sustained **dividend performance** for its shareholders. The dividend per share for the year was US\$0.76, an increase of 10.1 per cent on 2005, a larger increase than the 9.5 per cent increase in dividend per share reported in 2005. HSBC has delivered a compound rate of increase in dividends of 9.6 per cent per annum over the past 5 years.

[Back to Contents](#)

Basic **earnings per share** ("EPS") is a ratio that shows the level of earnings generated per ordinary share. EPS is one of two key performance measures used in rewarding employees and is discussed in more detail in the Director's Remuneration Report. EPS for 2006 was US\$1.40, an increase of 2.9 per cent on 2005. This demonstrated the benefit of diversified earnings as the losses in the US mortgage services business were more than compensated for by strong growth in other markets and products. In 2005, EPS grew by 15 percentage points over that reported in 2004.

Total shareholder return ("TSR") is used as a method of assessing the overall return to shareholders on their investment in HSBC, comprising both the growth in share value and declared dividends. TSR is a key performance measure in rewarding employees and is discussed in more detail in the Director's Remuneration Report. The TSR benchmark is an index set at 100 and measured over one, three and five years for the purpose of comparison with the performance of a group of competitor banks which reflect HSBC's range and breadth of activities. The TSR levels at the end of 2006 were 104.6, 122.0, and 148.4 over one, three and five years respectively. HSBC's TSR over one and three years has underperformed the benchmark. This is attributed largely to the impact on the share price of the current weakness in the US sub-prime mortgage business and investor preference over this time for companies with smaller market values, particularly those for which there is the possibility of participating in domestic or regional consolidation. Over five years HSBC's TSR outperformed the benchmark, reflecting its strong and consistent growth in profits and dividends.

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

Non-financial KPIs

HSBC has chosen four non-financial KPIs which are important to the future success of the Group in delivering its strategic objectives. These non-financial KPIs are currently reported internally within HSBC on a local basis. Going forward, a common framework is being established with considered definitions and metrics so that these KPIs can be published from next year.

Employee engagement

Employee engagement is a measure of employees' emotional and rational attachment to HSBC that motivates them to remain with the Group and align themselves wholeheartedly with its success.

HSBC regularly surveys its employees on a regional or business basis, achieving on average a response rate of over 80 per cent. In 2006 over 168,000 employees were surveyed.

From 2007 onwards, HSBC will launch a Group-wide employee engagement survey in conjunction with a leading external partner, which will include core questions designed to measure employee engagement levels consistently. This will be used to improve business performance through employee engagement, reward senior management for meeting and exceeding target engagement scores, and benchmark HSBC both internally and externally. The analysis of the survey results will be undertaken by the external partner, taking into account cultural norms and industry benchmarks. Survey results and action plans developed in response thereto will be communicated to all employees.

Brand perception

HSBC has conducted brand tracking surveys in its major Personal Financial Services markets for five years, assessing the strength of the brand by measuring awareness, consideration, momentum, image and differentiation. From 2007, HSBC will extend the exercise to include customers in HSBC's major Commercial Banking markets. The surveys will be conducted by accredited independent third party organisations, and will produce a blended measure which will compare HSBC's performance with its competitors in its major markets.

Customer satisfaction

HSBC has also regularly conducted customer satisfaction surveys in its main markets over many years. Going forward, HSBC will use a consistent measure of recommendation to gauge customer satisfaction with the services provided by the Group's Personal Financial Services and Commercial Banking businesses, and benchmark the measures of reported customer satisfaction against those reported in respect of the customers of its main competitors in each of these markets.

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Financial Review

(continued)

Key performance indicators / Financial summary

IT performance and systems reliability

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

The number of customer transactions processed is a measure of the ease with which customers can access IT-developed and supported systems, the extent to which these systems meet customer expectations and the success of the Group's IT function in meeting straight-through delivery processing targets.

Customer transactions processed

1 Interactive voice response system

HSBC's IT function establishes with its end users service level agreements for systems performance (e.g. systems up-time 99.9 per cent of the time and credit card authorisations within two seconds) and monitors the achievement of each of these commitments. The following chart shows the percentage of time throughout the year IT has consistently achieved all of its service level commitments. It is intended that comparisons of these numbers will be provided in the future.

Percentage of IT services meeting or exceeding targets in 2006

[Back to Contents](#)

Financial summary

Income statement

	Year ended 31 December		
	2006 US\$m	2005 US\$m	2004 US\$m
Interest income	75,879	60,094	50,471
Interest expense	(41,393)	(28,760)	(19,372)
Net interest income	34,486	31,334	31,099
Fee income	21,080	17,486	15,902
Fee expense	(3,898)	(3,030)	(2,954)
Net fee income	17,182	14,456	12,948
Trading income excluding net interest income	5,619	3,656	2,786
Net interest income on trading activities	2,603	2,208	□
Net trading income ¹	8,222	5,864	2,786
Net income from financial instruments designated at fair value	657	1,034	□
Net investment income on assets backing policyholders' liabilities	□	□	1,012
Gains less losses from financial investments	969	692	540
Dividend income	340	155	622
Net earned insurance premiums	5,668	5,436	5,368
Other operating income	2,546	2,733	1,613
Total operating income	70,070	61,704	55,988
Net insurance claims incurred and movement in policyholders' liabilities	(4,704)	(4,067)	(4,635)
Net operating income before loan impairment charges and other credit risk provisions	65,366	57,637	51,353
Loan impairment charges and other credit risk provisions	(10,573)	(7,801)	(6,191)
Net operating income	54,793	49,836	45,162
Employee compensation and benefits	(18,500)	(16,145)	(14,523)
General and administrative expenses	(12,823)	(11,183)	(9,739)
Depreciation of property, plant and equipment	(1,514)	(1,632)	(1,731)
Amortisation and impairment of intangible assets	(716)	(554)	(494)
Total operating expenses	(33,553)	(29,514)	(26,487)
Operating profit	21,240	20,322	18,675
Share of profit in associates and joint ventures	846	644	268
Profit before tax	22,086	20,966	18,943
Tax expense	(5,215)	(5,093)	(4,685)
Profit for the year	16,871	15,873	14,258
Profit attributable to shareholders of the parent company	15,789	15,081	12,918
Profit attributable to minority interests	1,082	792	1,340

- 1 *[Net trading income] comprises all gains and losses from changes in the fair value of financial assets and financial liabilities held for trading, together with related external interest income, interest expense and dividend income. The 2004 comparative figure does not include interest income and interest expense on trading assets and liabilities except for trading derivatives, nor does it include dividend income on trading assets and so is not strictly comparable with the figures for 2005 and 2006.*

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

HSBC made a profit before tax of US\$22,086 million, a rise of US\$1,120 million, or 5 per cent, compared with 2005. Incremental contributions to pre-tax profit from Metris in the US, the Argentine retail operations acquired from Banca Nazionale and Ping An Insurance in mainland China, less the profits of The Cyprus Popular Bank, which

was sold during the year, accounted for US\$347 million of the increase in pre-tax profit in the period. These represented the bulk of changes in the constitution of the Group. On an underlying basis, which is described on page 111, profit before tax increased by 3 per cent.

Average invested capital increased by US\$10.6 billion compared with 2005 and return on that capital fell slightly by 1.0 per cent to

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Financial Review

(continued)

Summary income statement

14.9 per cent. Revenue growth was 13 per cent and the cost efficiency ratio was broadly unchanged at 51.3 per cent; the Group's Tier 1 ratio strengthened to 9.4 per cent.

HSBC's results in 2006 reflected the benefits of diversification of earnings. There were a number of outstanding achievements, for example, exceeding US\$1 billion pre-tax profits for the first time in Mexico and the Middle East, and in each of the Group Private Banking and Commercial Banking businesses in the Rest of Asia-Pacific. HSBC added approximately US\$1 billion in extra pre-tax profits in the Rest of Asia-Pacific and globally in the Commercial Banking businesses.

However, results in 2006 also reflected a decline in pre-tax profits of around US\$725 million in the Group's personal businesses in the US as a portfolio of sub-prime mortgages purchased by a subsidiary of HSBC Finance (mortgage services) suffered much higher delinquency than had been built into pricing these products.

Earnings continued to be well diversified, both geographically and by customer group. Regionally, Asia including Hong Kong, had record results as did the Group's newly designated Latin America region, which combines Mexico and Central America with HSBC's South American businesses. Within the Customer Groups, Commercial Banking again delivered a record performance, as did Private Banking and Corporate, Investment Banking and Markets, which made strong progress in the areas in which the Group has been investing in recent years. Personal Financial Services declined as growth in Asia and Latin America was masked by the problems in the US mortgage services business.

The economic backdrop in 2006 was favourable. Global equity markets enjoyed strong gains for much of the year, encouraging expanded investment flows and creating a receptive marketplace for the high level of mergers and acquisitions and IPO activity which followed. However, in these favourable conditions, the cumulative effect of rising short-term rates, benign credit conditions and strong liquidity put pressure on interest margins.

The credit environment for corporate and commercial lending continued to be exceptionally good. However, on the back of slowing housing markets and rising interest rates, a marked deterioration was experienced in the sub-prime mortgage market in the US. This more than outweighed the non-recurrence in 2006 of loan impairment costs associated with a surge in bankruptcy filings in the US in the fourth quarter of 2005, and the effect of hurricane Katrina.

Net operating income before loan impairment charges and other credit risk provisions of US\$65,366 million was US\$7,729 million or 13 per cent higher than in 2005, 11 per cent higher on an underlying basis. Commercial Banking, Corporate, Investment Banking and Markets and Private Banking operations all achieved strong double-digit growth. Operating income performance was well spread geographically, with the strongest growth in HSBC's operations in Asia and in Latin America.

Loan impairment and other credit risk provisions, expressed as a percentage of gross average advances to customers, at 1.4 per cent, were 20 basis points higher in 2006 than the 1.2 per cent recorded in 2005. There was also a 20 basis point rise in the ratio of new loan impairment charges to gross average advances to customers, from 1.4 per cent in 2005 to 1.6 per cent in 2006. The charge of US\$10,573 million was US\$2,772 million, or 36 per cent, higher than in 2005, 30 per cent higher on an underlying basis. Of this increase, approximately 60 per cent arose in the Group's Personal Financial Services businesses in North America, with the major increase being in the US sub-prime mortgage portfolio acquired through mortgage services. Impairment charges in the UK were broadly stable as a percentage of lending to customers despite a rising trend of consumer recourse to debt

mitigation arrangements. There was also some credit deterioration in a few emerging market countries, notably in the first half of 2006, as a consequence of regulatory changes.

Total operating expenses of US\$33,553 million were US\$4,039 million or 14 per cent higher than in 2005, 11 per cent higher on an underlying basis. Much of the growth reflected investment to expand the Group's geographic presence and add product expertise and sales support. This expansion was most marked in Personal Financial Services in North America, and in Corporate, Investment Banking and Markets, where the cost efficiency ratio improved slightly as strong revenue growth offset the first full year effect of investment expenditure in previous years.

HSBC's share of profit in associates and joint ventures increased by US\$202 million, with improved contributions from The Saudi British Bank, Bank of Communications and Industrial Bank, supplemented by a first full year contribution from Ping An Insurance. HSBC's share of profits from investments in associates in the Rest of Asia-Pacific accounted for nearly a quarter of the profits from that region. For further detailed discussion and analysis by geographical segment of the Group's

[Back to Contents](#)

results see Report of the Directors: Business Review on page 31.

Year ended 31 December 2005 compared with year ended 31 December 2004

HSBC made a profit before tax of US\$20,966 million, a rise of US\$2,023 million or 11 per cent compared with 2004. Of this increase, US\$267 million was attributable to additional contributions of ten and two months from M&S Money and Bank of Bermuda respectively, one month's contribution from Metris, and the first full year effect of HSBC's investments in Bank of Communications and Industrial Bank.

As a result of the transition to full IFRSs, the format of the income statement changed. In particular, US\$685 million of what would, previously, have been included in non-equity minority interest, moved within the income statement and was classified as "Interest expense" in 2005, rather than "Profit attributable to minority interests". As the applicable IFRSs requiring these changes only came into effect from 1 January 2005, the comparative 2004 figures are presented on the previous basis.

On an underlying basis, which is described on page 111, profit before tax increased by 13 per cent.

Total operating income of US\$61,704 million was US\$5,716 million or 10 per cent higher than in 2004. On an underlying basis, total operating income also rose by 10 per cent. This reflected organic lending growth in all regions and expansion in transactional banking revenues from increased trade, funds under management, administration and custody activities. Strong growth was also seen in fixed income and credit trading. Operating income performance was well spread geographically with particularly strong growth in HSBC's operations in Latin America, the Middle East and the Rest of Asia-Pacific.

Loan impairment and other credit risk provisions as a percentage of gross average advances to customers was moderately higher in 2005 at 1.16 per cent than in 2004, 0.99 per cent. There was also a small rise in the percentage ratio of new loan impairment charges to gross average advances to customers from 1.41 in 2004 to 1.50 in 2005. The charge of US\$7,801 million was US\$1,610 million or 26 per cent higher than in 2004 and on an underlying basis 23 per cent higher. Of this increase, approximately half was driven by growth in lending, with the remainder attributable to the higher rate of new provisions and the non-recurrence of general provision releases benefiting 2004. Underlying credit

conditions in the UK were adversely affected by slower economic growth and changes in bankruptcy legislation. This was offset by improved credit experience in the US, notwithstanding the impact of hurricane Katrina and an acceleration of bankruptcy filings ahead of legislative changes in the fourth quarter of 2005. In Brazil, HSBC also experienced higher charges as increased credit availability, particularly in the consumer segment, led to over-indebtedness.

Total operating expenses of US\$29,514 million were US\$3,027 million or 11 per cent higher than in 2004, 9 per cent higher on an underlying basis. Much of the growth reflected investment to expand the Group's geographic presence and adding product expertise and sales support. This expansion was most marked in Personal Financial Services in the Rest of Asia-Pacific and in Corporate, Investment Banking and Markets, where investment spend peaked during 2005. In addition, business expansion in the Middle East and Latin America contributed to cost growth.

Productivity improvements achieved in the UK and Hong Kong allowed the Group to continue building its Personal Financial Services and Commercial Banking businesses in the Rest of Asia-Pacific, and expanding its capabilities in Corporate, Investment Banking and Markets, without deterioration in the Group's cost efficiency ratio. In the UK, the focus on improving utilisation of the existing infrastructure led to broadly flat costs in Personal Financial Services and Commercial Banking compared with underlying combined revenue growth of 10 per cent.

HSBC's cost efficiency ratio, which is calculated as total operating expenses divided by net operating income before loan impairment charges and other credit risk provisions, improved slightly to 51.2 per cent in 2005 from 51.6 per cent in 2004.

HSBC's share of profit in associates and joint ventures increased by US\$376 million, boosted by full year contributions from Bank of Communications and Industrial Bank in mainland China, and increased income from The Saudi British Bank, which reported a record performance on the back of a vibrant economy and a strong oil price.

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Financial Review

(continued)

Net interest income

Net interest income

	Year ended 31 December					
	2006		2005		2004	
	US\$m	%	US\$m	%	US\$m	%
By geographical region						
Europe	8,289	24.0	8,221	26.2	9,098	29.3
Hong Kong	4,685	13.6	4,064	13.0	3,638	11.7
Rest of Asia-Pacific	3,047	8.8	2,412	7.7	2,060	6.6
North America ¹	14,268	41.4	13,295	42.4	13,787	44.3
Latin America ¹	4,197	12.2	3,342	10.7	2,516	8.1
Net interest income ²	34,486	100.0	31,334	100.0	31,099	100.0

	Year ended 31 December		
	2006 US\$m	2005 US\$m	2004 US\$m
Net interest income ²	34,486	31,334	31,099
Average interest-earning assets	1,113,404	999,421	976,387
Gross interest yield (per cent) ³	6.82	6.01	5.17
Net interest spread (per cent) ⁴	2.94	2.84	2.97
Net interest margin (per cent) ⁵	3.10	3.14	3.19

1 In 2006, Mexico and Panama were reclassified from the North America segment to the Latin America segment. Comparative information has been restated accordingly.

2 [Net interest income] comprises interest income less interest expense on financial assets and liabilities which is not recognised as part of [Net trading income] or [Net income earned from financial instruments designated at fair value]. In 2004, all interest income and expense was included within [Net interest income] so these figures are not strictly comparable with those for 2005 and 2006.

3 Gross interest yield is the average annualised interest rate earned on average interest-earning assets ([AIEA]).

4 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.

5 Net interest margin is net interest income expressed as an annualised percentage of AIEA.

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

Net interest income of US\$34,486 million was 10 per cent higher than in 2005 and 7 per cent higher on an underlying basis. The commentary that follows is on an underlying basis.

Movements in net interest income were particularly influenced by the following factors:

•

rising short-term interest rates in US dollars and linked currencies, and in sterling, increased the value of low-cost deposits and transactional balances and increased the interest income earned from investing those balances. This was particularly relevant to the Personal Financial Services and Commercial Banking businesses in Asia and the UK, and also improved the value of cash balances within the Group's custody and payments and cash management businesses and increased the resultant investment income;

- the cumulative effect of higher short-term interest rates in most major currencies in recent years has been to flatten interest rate yield curves and to reduce the opportunities available to HSBC's balance sheet management operations to generate additional income. This reduced growth in net interest income compared with 2005 by some 2 percentage points;
- strong liquidity and benign credit conditions put pressure on lending margins in corporate and commercial banking and credit spreads tightened as a consequence. Increased competition for core deposits also reduced deposit spreads in certain markets;
- HSBC deployed an increased proportion of liabilities into trading assets. Reported net interest income includes the cost of internally funding these assets, while related revenue is included in trading income. This was particularly relevant to the UK, France and the US. The cost of funding net long positions is included within trading as an interest expense in HSBC's customer group reporting; and
- HSBC concentrated balance sheet expansion on attracting liabilities and, as a result, customer deposits, at constant currency but including acquisitions, grew by 3 percentage points more than customer loans.

In Europe, net interest income increased by 1 per cent. The benefit of balance growth in Personal Financial Services and Commercial Banking was substantially offset by the increased deployment of liabilities to the fund trading activity referred to above; there was a corresponding rise in trading income. This was most pronounced in the UK and France.

[Back to Contents](#)

In the UK, growth in Personal Financial Services was strong in savings and packaged current accounts, but mortgage and credit card lending also increased. In Commercial Banking, customer recruitment boosted growth in deposit balances and spreads widened, particularly on US dollar denominated accounts. Commercial lending balances were higher, in part reflecting the strong growth throughout 2005. In France, revenues declined despite growth in lending, due to competitive pricing pressures and the impact of older, higher-yielding hedges of the network's funding surplus maturing. Corporate, Investment Banking and Markets' balance sheet management revenues declined as the rising trend in short-term interest rates continued to flatten yield curves.

In Hong Kong, net interest income rose by 15 per cent. Deposit spreads widened with progressive interest rate rises, and balances increased as customers took advantage of higher rates. HSBC supported this growth with a number of promotions and marketing campaigns during the year. In Personal Financial Services, average savings and deposit balances rose by 7 per cent. The launch of a simplified mortgage pricing structure helped boost mortgage balances and grow market share. A clear focus on sales and targeted marketing helped achieve strong growth in credit card balances, and the number of cards in issue rose by 17 per cent to 4.6 million. Average corporate lending balances rose as the economy gained momentum and investment was channelled into mainland China. The benefit of these developments, however, was substantially offset by spread compression through the rising cost of funds, and lower balance sheet management revenues as short term interest rates continued to rise, and yield curves remained flat.

In the Rest of Asia-Pacific, a 25 per cent rise in net interest income was fuelled by balance sheet growth in Personal Financial Services and Commercial Banking. This reflected HSBC's continuing investment in growing the business through network expansion, customer recruitment and targeted marketing and promotions. In Personal Financial Services, the emphasis on the recruitment of HSBC *Premier* customers generated strong deposit growth throughout the region, which funded increased mortgage and credit card borrowing. Other unsecured lending balances also grew significantly, as HSBC expanded its consumer finance operations in India, Australia and Indonesia. In corporate and commercial banking, increased deposits raised through customer recruitment and through higher transactional balances in the payments and cash management and the custody businesses were

significant to the growth in net interest income. On the asset side, growth reflected strong demand for credit as regional economies continued to expand and trade flows increased.

In North America, net interest income increased by 3 per cent. In the US Personal Financial Services business, strong growth in mortgages, cards, and other personal unsecured non-credit card lending was funded by a 21 per cent rise in average deposits to US\$32.2 billion. This was led by the continued success of the online savings product which grew by US\$6 billion to US\$7 billion at 31 December 2006. Higher spreads in credit cards, reflecting a lower proportion of promotional balances and a degree of re-pricing, were in contrast with most other portfolios. Overall, asset spreads contracted, driven by the effect on funding costs of a succession of interest rate rises, while competitive pricing and customer migration to higher yielding products reduced spreads on deposits. Net interest income was boosted in Canada by strong lending to personal and commercial customers, supported by deposit raising initiatives. However, these benefits were partly offset by lower Corporate, Investment Banking and Markets' balance sheet management income as spreads narrowed as a result of higher short-term rates coupled with a flat yield curve in the US. The increased deployment of liabilities to fund trading activity also reduced growth in net interest income, with a corresponding increase in trading income.

In Latin America, net interest income increased by 17 per cent. In Mexico, deposit growth was boosted by the continuing success of the 'Tu Cuenta' packaged account in Personal Financial Services. Credit card, unsecured lending and mortgage balances also grew strongly, though the benefit of the latter was offset by competitive pressure on spreads. In Brazil, where the domestic economy improved and inflation remained low, rising consumer demand for credit, together with increased sales activity and customer recruitment, drove strong lending growth. Deposits rose through current accounts linked to the growing payroll loan business. Growth in Commercial Banking was mainly in the small and middle market customer segments. HSBC increased focus on these businesses through network expansion and the recruitment of additional sales staff throughout the region. In Corporate, Investment Banking and Markets, improved balance sheet management revenues and growth in the payments and cash management business were the major contributors to interest income growth.

Average interest earning assets of US \$1,113 billion were US\$114 billion, or 11 per cent, higher than in 2005. On an underlying basis,

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Financial Review

(continued)

Net fee income

growth was 10 per cent. HSBC's net interest margin was 3.10 per cent in 2006, compared with 3.14 per cent in 2005.

Year ended 31 December 2005 compared with year ended 31 December 2004

Net interest income of US\$31,334 million was US\$235 million, or 1 per cent, higher than in 2004.

Under IFRSs, HSBC's presentation of net interest income in 2005 was particularly affected by:

- the reclassification of certain preference dividends within non-equity minority interests as interest expense;
- the inclusion of certain loan origination fees and expenses as part of an effective interest rate calculation instead of being recognised in full on inception of the loan; and
- external interest income and expense on trading assets and liabilities now included within "Net trading income".

Adjusting for these changes and on an underlying basis, net interest income increased by 12 per cent. The commentary that follows is on this basis.

The benefit of strong growth in interest-earning assets globally more than offset the effect of spread compression from flattening yield curves in the major currencies. This latter phenomenon reduced opportunities for HSBC's balance sheet management operations to enhance margin by placing the Group's surplus liquidity longer term than the behaviouralised deposit funding base. In addition, short-term interest rate rises in the US reduced spreads on consumer finance loans.

In Europe, higher personal and commercial lending and increased deposit balances led to a 12 per cent increase in net interest income. UK Personal Financial Services balances grew strongly in mortgages, unsecured lending and cards, mainly funded by a 12 per cent increase in deposit and savings balances. In Turkey, card balances grew from increased marketing and working with HSBC's retail partners. Spreads tightened on UK personal lending, reflecting the introduction of preferential pricing for lower-risk and higher-value customers, and on savings, due to better pricing for customers. In Commercial Banking in the UK, lending and overdraft balances increased by 23 per cent, with growth particularly strong in the property, distribution and services sectors. Deposit balances grew by 11 per cent, partly from keen pricing, though this reduced deposit spreads. Yields on UK

corporate lending, which were lower largely as a result of competitive pressure, were only partly offset by higher loan balances, while lower balance sheet management income reflected the effect of rising short-term rates and flattening yield curves on balance sheet management revenues.

In North America, net interest income increased by 4 per cent. Growth in mortgage, card and unsecured personal lending balances was strong, offsetting spread contraction as the cost of funds rose with progressive interest rate rises. Core deposit growth benefited from expansion of the branch network and the launch of new savings products, including an online savings product which attracted a significant number of new customers. Treasury income from balance sheet management within Corporate, Investment Banking and Markets diminished as the rise in short-term interest rates limited opportunities to profit from placing the liquidity generated from

core banking operations over extended periods.

In Hong Kong, net interest income rose by 17 per cent. Rising interest rates reinvigorated demand for traditional savings products, driving increases in personal and commercial savings balances. Coupled with the rise in deposit spreads, which increased in line with interest rates, this led to a sharp rise in net interest income. Mortgage spreads contracted, however, as the gradual increase in yields during the year, in line with higher rates, was more than offset by rising funding costs. There was little net new lending for residential mortgages as interest rate rises cooled the residential property market in the second half of 2005. Economic growth in mainland China boosted commercial lending to the trade and manufacturing sectors, and property lending also increased. Treasury income remained under pressure, with rising short-term interest rates and a flat yield curve providing limited opportunities to profitably deploy surplus liquidity and increasing funding costs.

In the Rest of Asia-Pacific, net interest income increased by 24 per cent, reflecting business expansion and favourable economic conditions throughout the region. In the Middle East, buoyant oil-based economies stimulated demand for credit for property and infrastructure projects. Increasing personal and corporate wealth contributed to growth in deposit balances, while interest rate rises led to higher deposit spreads. General economic expansion created demand for consumption credit which boosted credit card lending. For the reasons noted above, treasury income from balance sheet management was weaker.

[Back to Contents](#)

In Latin America, the positive economic environment encouraged growth in personal and commercial lending, particularly in credit cards and vehicle finance, which led to a 32 per cent increase in net interest income. In Mexico, HSBC continued to lead the market in personal customer deposit growth. Recruitment of commercial customers was also strong. A significant rise in customer acquisition and the development of the Losango customer base in Brazil also contributed.

Average interest-earning assets increased by US\$23 billion, or 2 per cent, compared with 2004.

At constant exchange rates, and excluding the US\$84.7 billion of trading assets in 2004, average interest-earning assets increased by 11 per cent, reflecting strong growth in mortgages, personal lending and cards globally, and increased lending in Commercial Banking.

HSBC's net interest margin was 3.14 per cent in 2005 compared with 3.19 in 2004. For the reasons set out in the opening paragraphs, these figures were not strictly comparable as a result of presentation changes under IFRSs from 1 January 2005.

Net fee income

Year ended 31 December

	2006		2005		2004	
	US\$m	%	US\$m	%	US\$m	%
By geographical region						
Europe	7,108	41.4	6,299	43.6	5,980	46.2
Hong Kong	2,056	12.0	1,674	11.6	1,703	13.2
Rest of Asia-Pacific	1,622	9.4	1,340	9.3	1,041	8.0
North America ¹	4,766	27.7	3,952	27.3	3,197	24.7
Latin America ¹	1,630	9.5	1,191	8.2	1,027	7.9
Net fee income	17,182	100.0	14,456	100.0	12,948	100.0

Year ended 31 December

	2006 US\$m	2005 US\$m	2004 US\$m
Cards	5,708	4,699	3,987
Account services	3,633	3,132	2,779
Funds under management	2,718	1,831	1,479
Broking income	1,354	1,104	943
Insurance	1,017	1,082	1,001
Credit facilities ²	922	880	1,179
Global custody	797	656	564
Imports/exports	780	722	692
Unit trusts	520	388	498
Remittances	472	396	353
Underwriting	286	274	234
Corporate finance	255	211	193
Trust income	248	199	203
Maintenance income on operating leases	122	180	190
Mortgage servicing	97	76	80
Other	2,151	1,656	1,527

Total fee income	21,080	17,486	15,902
Less: fee expense	(3,898)	(3,030)	(2,954)
Net fee income	17,182	14,456	12,948

- In 2006, Mexico and Panama were reclassified from the North America segment to the Latin America segment. Comparative information has been restated accordingly.*
- Under IFRSs from 2005, a higher proportion of fees on credit facilities is dealt with as part of an effective interest rate calculation than previously. This change in accounting affects both the timing of fee income recognition and its presentation in the accounts. In accordance with the transition arrangements to IFRSs, the 2004 comparative figure is presented on the previous accounting basis.*

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

Net fee income of US\$17,182 million was 19 per cent higher than in 2005 or 16 per cent higher on an underlying basis. The commentary that follows is on an underlying basis.

- Robust global stock market performance, particularly in emerging markets, led to increased customer appetite for equity-based

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Financial Review

(continued)

Net fee income

products. HSBC responded by launching new investment products and increasing promotional activity, which contributed to higher unit trust, broking and custody fees.

- There was an increase in cards in issue, which drove higher transaction volumes and balances and led to a 16 per cent rise in card fee income, principally in the US;
- Strong equity market performance also benefited HSBC's asset management activities. Funds under management grew by 16 per cent and performance fees rose strongly, most notably in HSBC's BRIC (Brazil, Russia, India and China) funds and in the Hermitage Fund, a leading fund investing in Russia.
- The successful promotion of packaged account products which, together with increased customer numbers and higher transaction volumes, led to a 13 per cent rise in account services fees. Higher cross-border currency flows led to increased remittance income.
- Reduced sales of creditor insurance products in the UK were largely offset by higher fees in HSBC's Latin American insurance businesses, particularly in Argentina and Brazil.
- Increased taxpayer services fees, higher income from investment and other services provided by HSBC's insurance businesses, and increased corporate and WTAS advisory fees in the US contributed to the increase in other fee income.

In Europe, account service fees increased as a result of customer acquisition, higher sales of packaged products and increased transaction volumes. Rising stock markets led to higher sales of investment products and growth in funds under management, while product mix improvements and service enhancements also contributed to a rise in investment fees. Higher performance fees in respect of the Hermitage Fund contributed an additional US\$23 million in fee income, net of performance fees paid to the fund's investment advisor. Offsetting these increases, HSBC's decision to constrain unsecured lending growth in the UK resulted in lower creditor protection insurance fees.

In Hong Kong, a buoyant IPO market together with product launches and enhancements contributed to higher sales of investment products; this was augmented by increased transaction volumes following strong growth in local and regional equity markets. As global customers continued to seek investment opportunities in emerging markets, funds under management increased. Growth in cards in issue led to higher card fees.

In the Rest of Asia-Pacific, higher trade and remittance flows led to increased payments and cash management income. Investment flows into emerging market funds triggered growth in custody and funds administration fees, while rising equity markets and product launches contributed to increased investor demand and higher income from custody, brokerage and the sale of investments.

In North America, card fees increased as a result of higher balances and improved interchange rates, while private label card fees benefited from renegotiations with a number of merchants. Increases in 2006 were partly offset by the effect of FFIEC guidance, which limits certain fee billings for non-prime credit card accounts. Following its launch in 2005, activity within HSBC's mortgage-backed securities business increased rapidly during 2006. As a result, a greater proportion of loans originated by HSBC were sold to the secondary market and mortgage servicing fees grew accordingly, while income in the mortgage-backed securities business also rose. Tariff increases contributed to higher account service fees. Higher business volumes led to a rise in taxpayer services fees, while the WTAS business progressed strongly, expanding its customer base and reporting significantly higher fee income.

In Latin America, increased cards in circulation and improvements in activation times led to higher card issuing fees, while growth in the merchant customer base led to a rise in card acquiring income. Account servicing fees benefited from higher packaged account sales, enhancements to other current account products, price increases and greater transaction volumes. The expansion of HSBC's ATM network in Mexico drove higher ATM fees.

Year ended 31 December 2005 compared with year ended 31 December 2004

Net fee income of US\$14,456 million was US\$1,508 million or 12 per cent higher than in 2004. Under IFRSs, a greater proportion of fees relating to the provision of credit facilities is now amortised and accounted for in net interest income as part of an effective interest rate calculation than was the case before 1 January 2005. This resulted in a reduction in reported net fee income of approximately 4 per cent. Excluding this effect and on an underlying basis, growth in net fee income was 14 per cent and the comments that follow are presented on this basis. The principal drivers of this growth were:

- the increase in card fee income, reflecting strong growth in personal credit card sales across the Group and increased transaction volumes;

[Back to Contents](#)

- increased customer numbers, higher transaction volumes, an increase in packaged accounts and the selective management of tariffs led to an 11 per cent increase in account services fees;
- in Private Banking, the introduction of a wider range of alternative investment products and services generated higher fee income;
- increased demand for credit among personal and commercial customers drove mortgage and lending fees up by 11 per cent; and
- rising equity markets and renewed interest in emerging markets led to higher global custody, broking and asset management fees.

Offsetting these positive trends, after a strong run of growth, fee income from unit trust sales in Hong Kong fell as rising interest rates made traditional deposit products more attractive.

In Europe, fee income increased by 9 per cent. Higher personal and commercial lending volumes led to a 19 per cent increase in credit fees. Card fee income rose by 22 per cent, principally in the UK which benefited from higher customer numbers and greater card utilisation. Account service fees increased by 9 per cent, reflecting increased customer numbers, the launch of a new packaged product in the UK and the introduction of a Small Business Tariff in Commercial Banking. Buoyant equity markets benefited custody fees, which grew as a result of both increased asset values and strong new business volumes. Private Banking fee income was 12 per cent higher than in 2004 following increases in client assets under management and transaction volumes.

In Hong Kong, net fee income was in line with 2004. Unit trust fees decreased by 42 per cent as Personal Financial Services customers switched to traditional deposit savings and shorter-term investment products. The launch of 173 new open-ended funds established HSBC as the leading investment service provider in Hong Kong. This, together with the successful attraction of client assets in Private Banking, contributed to a rise in income from funds under management. Credit card fee

income increased by 18 per cent, reflecting growth in cardholder spending as HSBC strengthened its position as the largest credit card issuer in Hong Kong. In Commercial Banking, net fees increased as trade services, insurance and lending income rose. However, lower Structured Finance revenues led to reduced Corporate, Investment Banking and Markets fees.

Net fee income in the Rest of Asia-Pacific rose by 28 per cent from higher card transaction volumes and increased account service fees in response to the expansion of the Personal Financial Services business in the region. Rising equity markets, buoyant regional economies and an increase in personal wealth combined with the launch of new products to increase sales of investment products to personal customers. Client assets in Private Banking also grew. Global Transaction Banking revenues increased in line with transaction volumes following investment in 2004 to expand capabilities. Custody fees grew by 29 per cent as a result of improved investor sentiment and rising local equity markets. Trade services income rose by 13 per cent, reflecting strong trade flows.

In North America, net fee income grew by 23 per cent. Card fee income grew as a result of higher transactions, increased receivables and improvements in the interchange rate, while US mortgage lending fees benefited from lower refinancing prepayments and the consequent release of impairment provisions on mortgage servicing rights. Investment banking fees increased in response to HSBC's success in attracting customers with an expanded range of products.

Net fee income in Latin America increased by 17 per cent, principally due to higher card, lending and current account servicing fees. Increased card fees reflected higher spending in Brazil and Argentina, as well as strong growth in the cards base in Mexico. Lending growth was predominantly volume driven, while current account fees benefited from increased customer numbers, tariff increases in Brazil and Argentina and higher transaction-driven ATM and remittance income in Mexico.

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Financial Review

(continued)

*Net trading income / Net income from financial instruments
designated at fair value*

Net trading income

	Year ended 31 December					
	2006		2005		2004	
	US\$m	%	US\$m	%	US\$m	%
By geographical region						
Europe	4,529	55.1	3,036	51.7	997	35.8
Hong Kong	617	7.5	546	9.3	659	23.7
Rest of Asia-Pacific	1,181	14.4	860	14.7	494	17.7
North America ¹	1,358	16.5	885	15.1	509	18.3
Latin America ¹	537	6.5	537	9.2	127	4.5
Net trading income	8,222	100.0	5,864	100.0	2,786	100.0

¹ In 2006, Mexico and Panama were reclassified from the North America segment to Latin America. Comparative information has been restated accordingly.

	Year ended 31 December		
	2006 US\$m	2005 US\$m	2004 US\$m
Trading activities	5,465	3,884	2,786
Net interest income on trading activities	2,603	2,208	□
Other trading income			
Hedge ineffectiveness:			
□ on cash flow hedges	(122)	(96)	□
□ on fair value hedges	16	14	□
Non-qualifying hedges	260	(146)	□
Net trading income	8,222	5,864	2,786

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

Net trading income increased significantly in comparison with 2005, reflecting the investment made in widening Global Markets' product range and developing its sales and execution capabilities. Positive revenue trends were recorded in key product areas, although the rate of income growth slowed in the second half of the year, principally due to lower market volatility and a decrease in deal volumes in the third quarter. The cost of internal funding on long positions is excluded from the reported □Net trading income□ and included within the □Net interest income□ line. However, this cost has been reinstated in □Net trading income□ in HSBC's customer group reporting.

Income from structured derivatives grew by 74 per cent, as investments in technical expertise and systems enabled HSBC to address a broader spectrum of client needs. Increased market volatility, together with expansion in the provision of structured fund products, resulted in higher customer volumes. As the business matured and markets deepened and became more transparent, revenues were boosted by a rise of US\$193 million in the recognition of income deferred in previous periods.

Foreign exchange income remained strong throughout 2006, principally driven by an increase in customer activity encouraged by US dollar weakness and volatility in emerging markets. In the metals

trading business, revenues doubled, primarily due to the underlying strength in precious metals and increased price volatility.

Within the Credit and Rates business, higher gains from interest rate derivatives and emerging market bonds reflected increased volumes of new deals, a tightening of credit spreads and greater interest rate volatility.

In Europe, a significant increase in trading income was driven by higher foreign exchange flows and a greater focus on emerging market products. Overall, customer volumes rose, as increased hedging activity and a change in risk appetite among investors drove a general improvement in market sentiment towards developing economies.

On an underlying basis trading income in the Rest of Asia-Pacific grew by 35 per cent, driven by HSBC's strong distribution network and experience in developing markets activity, which contributed to particularly strong increases reported in India the Middle East and mainland China.

Performance in HSBC's operations in the US remained robust benefiting, in part, from the first full year contribution from the US residential mortgage-backed securities business and successful product launches in structured derivatives.

[Back to Contents](#)

Year ended 31 December 2005 compared with year ended 31 December 2004

Net trading income of US\$5,864 million rose by 110 per cent against 2004. Under IFRSs, HSBC's presentation of trading income for 2005 reclassified under net trading income external interest income and dividend income on trading assets and interest expense on trading liabilities.

The external funding of long trading positions is reported separately within "Net interest income on trading activities"; in the 2004 comparatives this was included within "Interest expense". The net effect of these adjustments added approximately US\$2.9 billion to net trading income.

In the segmental analysis, both net internal funding and net external interest income on trading activities are reported as "Net interest income on trading activities". The offset to the net internal funding is reported as "Net interest income" within the lending customer group. The resulting "Net trading income" line 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 interest income and interest expense and dividends received.

Income from trading activities rose, reflecting positive revenue trends on core products within Global Markets following the investment made in

client-facing trading capabilities. In Europe, revenues were boosted from higher volumes through electronic trading platforms and from the expansion of primary dealing activity in European government bond markets. In the US, the benefit of favourable movements on credit spreads was compounded by the non-recurrence of losses experienced in the industrial sector in 2004.

In Asia, volatility in the value of the Korean won against the US dollar, the introduction of a managed float for Malaysian ringgit and the enhancement of capabilities coupled with greater focus on trading regional currencies in the Middle East all contributed to higher foreign exchange revenues. In Europe, the weakening euro and market volatility following the general election in the UK and the French referendum on the EU constitutional treaty afforded opportunities to increase foreign exchange revenues.

Derivatives activity grew strongly as structured product capabilities were added in the credit, equity, and interest rate and foreign exchange areas. Further benefit was derived from the greater focus put on client-driven risk management and the investment made in sales and execution expertise in previous years. In accordance with IFRSs, the inception profits on certain derivative transactions are deferred as described in Note 17 on the Financial Statements.

Net income from financial instruments designated at fair value

	Year ended 31 December 2006		At 31 December 2006	
	Net income US\$m	%	Assets US\$m	Liabilities US\$m
By geographical region				
Europe	144	21.9	12,164	32,630
Hong Kong	260	39.6	4,745	4,291
Rest of Asia-Pacific	79	12.0	1,729	410
North America	(63)	(9.6)		32,880
Latin America	237	36.1	1,935	
Net income from financial instruments designated at fair value	657	100.0	20,573	70,211

	Year ended 31 December 2005		At 31 December 2005	
	Net income US\$m	%	Assets US\$m	Liabilities US\$m
By geographical region				
Europe	362	35.0	9,077	27,442
Hong Kong	(6)	(0.6)	3,909	3,999
Rest of Asia-Pacific	58	5.6	872	300
North America	434	42.0	□	29,934
Latin America	186	18.0	1,188	154
Net income from financial instruments designated at fair value	1,034	100.0	15,046	61,829

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Financial Review

(continued)

*Net income from financial instruments designated at fair value /
Gains less losses from financial investments*

	2006 US\$m	2005 US\$m
Income from assets held to meet liabilities under insurance and investment contracts	1,552	1,760
Change in fair value of liabilities to customers under investment contracts	(1,008)	(1,126)
Movement in fair value of HSBC's long-term debt issued and related derivatives	(35)	403
	<hr/>	<hr/>
□ change in own credit spread on long-term debt	(388)	(70)
□ other changes in fair value	353	473
Income from other instruments designated at fair value	148	(3)
	<hr/>	<hr/>
Net income from financial instruments designated at fair value	657	1,034
	<hr/>	<hr/>

HSBC utilised □Amendment to IAS 39 Financial Instruments: Recognition and Measurement: the Fair Value Option□ with effect from 1 January 2005. HSBC may designate financial instruments at fair value under the option in order to remove or reduce accounting mismatches in measurement or recognition, or where financial instruments are managed, and their performance is evaluated, together on a fair value basis. All income and expense on financial instruments for which the fair value option was taken were included in this line except for issued debt securities and related derivatives, where the interest components were shown in interest expense.

HSBC used the fair value designation principally in the following instances:

- for certain fixed-rate long-term debt issues whose interest rate characteristic has been changed to floating through interest rate swaps, as part of a documented interest rate management strategy. Approximately US\$56 billion (2005: US\$51 billion) of the Group's debt issues have been accounted for using the fair value option. The movement in fair value of these debt issues includes the effect of own credit spread changes and any ineffectiveness in the economic relationship between the related swaps and own debt;
- as credit spreads narrow accounting losses are booked, and the reverse is true in the event of spreads widening. Ineffectiveness arises from the different credit characteristics of the swap and own debt coupled with the sensitivity of the floating leg of the swap to changes in short-term interest rates. In addition, the economic relationship between the swap and own debt can be affected by relative movements in market factors, such as bond and swap rates, and the relative bond and swap rates at inception. The size and direction of the accounting consequences of changes in own credit spread and ineffectiveness can be volatile from period to period, but do not alter the cash flows envisaged as part of the documented interest rate management strategy;
- for certain financial assets held by insurance operations and managed at fair value to meet liabilities under insurance contracts (approximately US\$6 billion of assets); and
- for financial liabilities under investment contracts and the related financial assets, when the change in value of the assets is correlated with the change in value of the liabilities to policyholders (approximately US\$12 billion of assets and related liabilities).

Net income from assets designated at fair value and held to meet liabilities under insurance and investment contracts is correlated with changes in liabilities under the related investment and insurance contracts. Under IFRSs, liabilities under investment contracts are classified as financial instruments. There is, however, a

mismatch in presentation of the insurance business results for which asset returns are included within [Net income from financial instruments designated at fair value] with the related change in the value of the insurance contract liabilities included within [Net insurance claims incurred and movement in policyholders' liabilities].

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

Net income from financial instruments designated at fair value decreased compared with 2005. This was primarily driven by a narrowing (i.e. improvement) in credit spreads on certain fixed-rate long-term debt issued by HSBC Finance and lower net mark-to-market movements on this debt and the related interest rate swaps. During 2006, HSBC Finance's debt received improved ratings from both Moody's and Standard and Poor's (S&P). Perversely, this improvement generated accounting losses of some US\$388 million which will reverse over the residual maturity of the debt instruments.

Income from assets held to meet liabilities under insurance and investment contracts was some 12 per cent lower, reflecting movements in the market

[Back to Contents](#)

values of assets. The increase in the fair value of liabilities under investment contracts was 10 per cent lower than in 2005.

Year ended 31 December 2005 compared with year ended 31 December 2004

The introduction of the new categories of financial instruments under IAS 39 on 1 January 2005 has led to a change in income statement presentation for the results of HSBC's life insurance business. In 2005, income from assets designated at fair value and held to meet liabilities under insurance and investment contracts of US\$1,760 million is reported under "Net income from financial instruments designated at fair value". In 2004, the corresponding amounts were reported within "Net investment income on assets backing policyholders' liabilities".

Income from assets designated at fair value and held to meet liabilities under insurance and investment contracts during 2005 was correlated with increases in liabilities under the related investment and insurance contracts. Under IFRSs, only investment contracts can be designated as financial instruments. Changes in the liability under these contracts, therefore, like the related assets, were included within the heading "Net income from financial instruments designated at fair value". The element of the increase in liabilities under insurance contracts that reflected investment performance was reported separately within "Net insurance claims incurred and movements in policyholders' liabilities". In 2004, investment income on assets backing policyholder liabilities was offset against the movement in policyholders' liabilities without distinction between insurance and investment contracts.

Gains less losses from financial investments

	Year ended 31 December					
	2006		2005		2004	
	US\$m	%	US\$m	%	US\$m	%
By geographical region						
Europe	624	64.4	439	63.4	154	28.5
Hong Kong	162	16.7	108	15.6	175	32.4
Rest of Asia-Pacific	41	4.2	18	2.6	17	3.1
North America ¹	58	6.0	47	6.8	147	27.3
Latin America ¹	84	8.7	80	11.6	47	8.7
Gains less losses from financial investments	969	100.0	692	100.0	540	<u>100.0</u>

	Year ended 31 December		
	2006 US\$m	2005 US\$m	2004 US\$m
Net gain from disposal of:			
□ debt securities	252	138	202
□ equity securities	702	505	296
□ other financial investments	15	7	42
	969	650	540
Recovery of impairment losses	□	42	□
Gains less losses from financial investments	969	692	540

- 1 *In 2006, Mexico and Panama were reclassified from the North America segment to Latin America. Comparative information has been restated accordingly.*

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

HSBC reported net gains of US\$969 million from the disposal of available-for-sale financial investments during 2006, 40 per cent higher than in 2005. On an underlying basis, gains were 35 per cent greater than in 2005. Gains from financial investments were mainly attributable to the following transactions:

- a gain of US\$93 million arising from the partial redemption of HSBC's investment in MasterCard Incorporated following its IPO in May. The gain was distributed across all geographic regions as most HSBC Group banks were members of MasterCard;
- a gain of US\$101 million on the sale of part of HSBC's stake in UTI Bank Limited, an Indian retail bank;

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Financial Review

(continued)

Net earned insurance premiums / Other operating income

- the partial sale by Private Banking of a holding in the Hermitage Fund contributed a gain of US\$117 million for the year; and
- the sale of a portfolio of structured finance investments, classified as debt securities, contributed a gain of US\$112 million.

Year ended 31 December 2005 compared with year ended 31 December 2004

The net gain of US\$692 million from the disposal of available-for-sale financial investments was 28 per cent higher than in 2004. Lower income from the disposal of debt securities was more than compensated for by an increase in gains from the disposal of private equity investments, particularly in HSBC's European operations.

Net earned insurance premiums

	Year ended 31 December					
	2006		2005		2004	
	US\$m	%	US\$m	%	US\$m	%
By geographical region						
Europe	1,298	22.9	1,599	29.4	1,875	34.9
Hong Kong	2,628	46.3	2,334	42.9	2,247	41.9
Rest of Asia-Pacific	174	3.1	155	2.9	97	1.8
North America ¹	492	8.7	477	8.8	450	8.4
Latin America ¹	1,076	19.0	871	16.0	699	13.0
Net earned insurance premiums	5,668	100.0	5,436	100.0	5,368	<u>100.0</u>

	Year ended 31 December		
	2006	2005	2004
	US\$m	US\$m	US\$m
Gross insurance premium income	6,455	6,152	6,022
Reinsurance premiums	(787)	(716)	(654)
Net earned insurance premiums	5,668	5,436	5,368

1 In 2006, Mexico and Panama were reclassified from the North America segment to Latin America. Comparative information has been restated accordingly.

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

Net earned insurance premiums of US\$5,668 million were 4 per cent higher than in 2005, 3 per cent on an underlying basis. The commentary that follows is on an underlying basis.

In Europe, net earned premium income decreased by 19 per cent to US\$1,298 million. This was largely in the UK, where lower sales of single premium insurance contracts, a lower market appreciation of investment assets and the effect of changes in reinsurance arrangements were the principal drivers of the decrease.

In Hong Kong, net earned premium income increased by 13 per cent, driven by the life insurance business. New products, many designed to meet financial needs identified in HSBC's global study on the future of retirement, were supported by increased promotional and marketing activity, and the development of internet and telephone distribution channels. Sales rose in consequence.

In the Rest of Asia-Pacific net earned premium income rose by 5 per cent growth to US\$174 million. This was concentrated in Singapore and reflected the success of new product launches, supported by increased marketing. Increased sales of individual life policies were the main driver of the growth. HSBC continued to expand its insurance business across the Rest of Asia-Pacific with a number of initiatives including the establishment of HSBC's first Islamic insurance company in Malaysia.

In North America, the modest rise in net premium income to US\$492 million reflected growth from new life business underwritten in 2006, which was substantially offset by a decline in the non-life business.

Improved cross-selling drove growth across Latin America, and income rose by 18 per cent to US\$1,076 million. In Mexico, growth in individual life, casualty and motor insurance was partly offset by increased reinsurance costs. In Brazil, growth was led by strong sales of both life and pension products. In Argentina, increased advertising partnerships with established local consumer brands and internal cross-selling initiatives led to a rise in motor, home and extended-warranty insurance premium income. This

[Back to Contents](#)

was, in part, offset by the effects of the disposal of the Brazilian general insurer HSBC Seguros during the latter half of 2005, which resulted in a significant reduction in non-life premium income.

Year ended 31 December 2005 compared with year ended 31 December 2004

Net earned insurance premiums of US\$5,436 million increased by US\$68 million compared with 2004. On an underlying basis, net earned insurance premiums were in line with 2004.

Under IFRSs, in 2005 there were changes in the presentation of certain aspects of HSBC's insurance business, which are now treated as liabilities under investment contracts. Investment income from these products was reported as [Net income from financial investments designated at fair value]. Income that was previously reported as [Net earned insurance premiums] was taken directly to the balance sheet as customer liabilities, with a corresponding movement in net insurance claims. Net insurance claims fell to a greater extent than premium income, due to the additional impact of the reclassification of the fair value movement in respect of liabilities under investment contracts.

The commentary that follows excludes the presentational changes discussed above, and is on an underlying basis.

Higher premium income in Europe was due to an increased uptake of creditor protection products in the UK. The increase in premiums in Hong Kong reflected HSBC's continued emphasis on the growth and development of its insurance proposition. Higher volumes of life assurance new business were directly driven by the launch of new endowment products, augmented by HSBC's leading position in online personal insurance provision. In addition, greater demand for private medical insurance products was driven by the public response to government deliberation over reforms to healthcare financing. Investment in HSBC's insurance business included the establishment of a new Commercial Banking insurance division in October, which positively contributed to higher volumes of new business.

In the Rest of Asia-Pacific, the increase in premiums was mainly attributable to growth in the number of personal insurance policies, resulting from an expansion of HSBC's insurance operations in the region.

In North America, increased cross-sales of insurance products through the branch network, combined with strong sales of other personal insurance-related products, resulted in an increase in net earned insurance premiums.

On an underlying basis, net earned insurance premiums in Latin America were broadly in line with 2004.

Other operating income

	Year ended 31 December					
	2006		2005		2004	
	US\$m	%	US\$m	%	US\$m	%
By geographical region						
Europe	1,428	35.4	1,603	43.7	1,175	52.4
Hong Kong	834	20.6	805	21.9	536	23.9
Rest of Asia-Pacific	765	18.9	335	9.1	146	6.5
North America ¹	922	22.8	642	17.5	341	15.2
Latin America ¹	91	2.3	286	7.8	46	2.0

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	4,040	100.0	3,671	100.0	2,244	<u>100.0</u>
Intra-HSBC elimination	(1,494)		(938)		(631)	
Other operating income	2,546		2,733		1,613	

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Financial Review

(continued)

Other operating income / Net insurance claims incurred

	Year ended 31 December		
	2006 US\$m	2005 US\$m	2004 US\$m
Rent received	687	859	793
Gain/(loss) on disposal of assets held for resale	28	11	(93)
Valuation gains on investment properties	164	201	99
Gain on disposal of property, plant and equipment, and non-financial investments	781	703	267
Gain on disposal of operating leases	□	26	□
Change in present value of in-force long-term insurance business	40	40	71
Other	846	893	476
Other operating income	2,546	2,733	1,613

1 In 2006, Mexico and Panama were reclassified from the North America segment to the Latin America segment. Comparative information has been restated accordingly.

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

Other operating income of US\$2,546 million was 7 per cent lower than in 2005, 9 per cent lower on an underlying basis. The commentary that follows is on an underlying basis.

In Europe, other operating income declined by 14 per cent. This largely resulted from the non-recurrence of one-off gains from the restructuring and syndication of assets in Global Investment Banking in 2005. Gains on private equity were also lower. There was a 29 per cent fall in rental income, with a compensating effect on operating expenses, following the sale of the operational functions of HSBC's vehicle financing and fleet management business in 2005, combined with the non-recurrence of gains made in that year on disposal of structured finance leases in the UK. This decline was partly offset by profit recognised on the sale of HSBC's stake in The Cyprus Popular Bank Limited of US\$93 million, and income from UK branch sale and lease-back transactions.

In Hong Kong, the modest increase in other operating income reflected profits earned from the sale of the former head office building of Hang Seng Bank and income received from the transfer of the credit card acquiring business into a joint venture between HSBC and Global Payments Inc. These factors were partly offset by lower revaluation gains on Hang Seng Bank's investment properties following a slowdown in the rate of property price appreciation and the non-recurrence of the disposal of a leasehold residential property.

Other operating income in the Rest of Asia-Pacific more than doubled, reflecting profits earned from various business disposals in Australia and the sale of an office building in Japan. Higher levels of activity at the Group Service Centres resulted in rising income in the region and contributed further to the increase.

In North America, the 42 per cent increase largely resulted from gains on the disposal of various investments and real estate, and higher lease income from property investments by Amanah Finance.

The 73 per cent decline in Latin America was mainly driven by the non-recurrence of the receipt of coverage bonds issued as compensation for asymmetric pesification in Argentina last year. The non-recurrence of the gain on sale of the insurance underwriter, HSBC Seguros, in Brazil in 2005 (US\$89 million) contributed further to the reduction.

Year ended 31 December 2005 compared with year ended 31 December 2004

Other operating income of US\$2,733 million was US\$1,120 million higher than in 2004. On an underlying basis, other operating income grew by 69 per cent.

The commentary that follows is on an underlying basis.

In Europe, the increase in other operating income was largely driven by increased rental income on the leasing of train rolling stock, higher disposals of assets and a number of private equity realisations.

In Hong Kong, higher other operating income was driven mainly by an increase in market value of the investment property portfolio and the disposal of a leasehold residential property. HSBC's investment properties are located principally in Hong Kong. Under IFRSs, valuation movements on investment properties are reflected in the income statement rather than through revaluation reserves. Within Hong Kong, the commercial property sector enjoyed good growth as the economy grew and vacant space fell markedly with a corresponding rise in rents.

The increase in other operating income in the Rest of Asia-Pacific was, in part, due to gains

[Back to Contents](#)

realised on the sale of the Group's asset management operations in Australia.

Other operating income in North America rose by 83 per cent, in part due to improved revenues from the sale of consumer real estate owned assets, higher rental income and disposals of property, plant and equipment.

In Latin America, other operating income increased by US\$240 million, primarily as a result of the sale of the insurance underwriter HSBC Seguros de Automoveis e Bens Limitada in Brazil, and the receipt of compensation and coverage bonds in Argentina. The receipt of non-core income in

Mexico from the distribution of third-party products through the HSBC network contributed further to the increase.

HSBC's rental income mainly arose from leasing in the UK. Europe accounted for 80 per cent of total rental income; the remainder was attributable to North America and Hong Kong.

The increase in the "Other" caption was largely driven by the increase in Latin America, reflecting the receipt of compensation and coverage bonds in Argentina, increased revenues from "capitalisation" products in Brazil and the receipt of non-core income in Mexico as noted above.

Net insurance claims incurred and movement in policyholders' liabilities

	Year ended 31 December					
	2006 US\$m	%	2005 US\$m	%	2004 US\$m	%
By geographical region						
Europe	531	11.3	818	20.1	1,628	35.1
Hong Kong	2,699	57.4	2,059	50.6	2,154	46.5
Rest of Asia-Pacific	192	4.1	166	4.1	82	1.8
North America ¹	259	5.5	232	5.7	236	5.1
Latin America ¹	1,023	21.7	792	19.5	535	11.5
Net insurance claims incurred and movement in policyholders' liabilities	4,704	100.0	4,067	100.0	4,635	100.0

	Year ended 31 December		
	2006 US\$m	2005 US\$m	2004 US\$m
Gross insurance claims and movement in policyholders' liabilities	5,072	4,153	5,220
Reinsurers' share of claims incurred and movement in policyholders' liabilities	(368)	(86)	(585)
Net insurance claims incurred and movement in policyholders' liabilities	4,704	4,067	4,635

¹ In 2006, Mexico and Panama were reclassified from the North America segment to the Latin America segment. Comparative information has been restated accordingly.

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

Net insurance claims incurred and movement in policyholders' liabilities of US\$4,704 million were 16 per cent higher than in 2005, 15 per cent on an underlying basis. The commentary that follows is on an underlying basis.

Net insurance claims incurred and the movement in policyholders' liabilities arise from both life and non-life insurance business. For non-life business, amounts reported here represent the cost of claims paid during the year and the estimated cost of notified claims. For life business, the main elements of claims are the liability to policyholders that is 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.

In Europe, net insurance claims incurred and movement in policyholders' liabilities decreased by 35 per cent to US\$531 million, primarily driven by lower sales of critical illness and creditor protection products, along with the effect of adverse movements in fixed interest rate markets on the value of policyholders' liabilities.

Net insurance claims and movement in policyholders' liabilities in Hong Kong increased by 31 per cent, predominantly in the life insurance business, in which reserves for policyholders' liabilities rose with business growth, together with the rising value of investments. Growth in the

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Financial Review

(continued)

Net insurance claims / Loan impairment charges

underwriting of accident and health business resulted in higher non-life insurance claims reserves.

Net insurance claims and movement in policyholders' liabilities in North America rose by 12 per cent to US\$259 million, mainly reflecting an increase in reserves for new life insurance business underwritten in 2006.

In Latin America, higher sales of life and pension fund products led to an increase in net insurance claims incurred and movement in policyholders' liabilities of 24 per cent to US\$1,023 million. Lower movements in the non-life insurance liabilities were due to the sale of the non-life insurance business, HSBC Seguros, in Brazil during the latter half of 2005.

Year ended 31 December 2005 compared with year ended 31 December 2004

Net insurance claims incurred and movement in policyholders' liabilities of US\$4,067 million decreased by 12 per cent compared with 2004. On an underlying basis, net insurance claims incurred decreased by 13 per cent.

As with net earned insurance premiums, the primary reason for the reduction was the required reclassification under IFRSs in 2005 of policyholders' liabilities in respect of long-term

insurance contracts which were reclassified as 'Liabilities to customers under investment contracts'. As a consequence, reported net insurance claims incurred and movement in policyholders' liabilities reduced.

The majority of HSBC's non-life insurance business largely relates to the provision of personal insurance products. Minimal impact from hurricane damage in the US and a lack of significant claims events during 2005 resulted in a relatively stable claims experience, augmented by negligible prior-year reserve development in respect of 2004.

Excluding the effect of the above reclassification, the most significant reduction in net claims occurred in Europe, due to the effect of revised actuarial valuations of existing life insurance policies in the UK life operation.

The reinsurers' share of claims incurred and movement in policyholder liabilities in 2004 included the renegotiation of a reinsurance treaty in the UK life operation, in which a greater proportion of risk was transferred to the reinsurer. The subsequent implementation of a revised liability valuation system in 2005 reduced the amount of reserves held for liabilities in respect of income protection products, bringing additional benefits in terms of capital efficiency of the UK life operation.

Loan impairment charges and other credit risk provisions

	Year ended 31 December					
	2006 US\$m	%	2005 US\$m	%	2004 US\$m	%
By geographical region						

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Europe	2,155	20.4	1,929	24.7	1,033	16.8
Hong Kong	172	1.6	146	1.9	(220)	(3.6)
Rest of Asia-Pacific	512	4.8	134	1.7	89	1.4
North America ¹	6,796	64.3	4,916	63.0	5,036	81.3
Latin America ¹	938	8.9	676	8.7	253	4.1
	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>
Total loan impairment charges and other credit risk provisions	10,573	100.0	7,801	100.0	6,191	100.0
	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>

As a percentage of net operating income before loan impairment charges and other credit risk provisions		16.2		13.5		12.1
Impairment charges on loans and advances to customers as a percentage of gross average loans and advances to customers		1.4		1.2		1.4

¹ In 2006, Mexico and Panama were reclassified from the North America segment to the Latin America segment. Comparative information has been restated accordingly.

[Back to Contents](#)

	Year ended 31 December		
	2006 US\$m	2005 US\$m	2004 US\$m
Loan impairment charges ¹			
New allowances net of allowance releases	11,326	8,354	7,606
Recoveries of amounts previously written off	(779)	(494)	(913)
	10,547	7,860	6,693
Individually assessed allowances	458	518	□
Collectively assessed allowances	10,089	7,342	□
General provisions	□	□	(498)
Other credit risk provisions	26	(59)	(4)
Total loan impairment charges and other credit risk provisions	10,573	7,801	6,191
Customer impaired loans	13,785	11,446	12,427
Customer loan impairment allowances	13,578	11,357	12,542

1 *Loan impairment charges in 2004 refer to specific provisions.*

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

The charge for loan impairments and other credit risk provisions was US\$10,573 million, a 36 per cent increase over that reported in 2005. The analysis that follows is on an underlying basis.

On an underlying basis, charges increased by 30 per cent. This reflected:

- increased loss experience in the US mortgage services business, particularly in second lien, portions of first lien and adjustable rate mortgages acquired from correspondent brokers and banks in 2005 and in the first half of 2006;
- 10 per cent underlying lending growth (excluding lending to the financial sector and settlement accounts), notably in the UK, the US, Mexico, Brazil and Asia;
- the continuing effect in the UK of consumer recourse to formal debt mitigation arrangements;
- credit deterioration, principally in the first half of 2006, in unsecured personal and credit card lending in Taiwan and Indonesia; offset by
- the non-recurrence of a surge in bankruptcy filings in the US in the fourth quarter of 2005 and the effect of hurricane Katrina; and
- a continued benign commercial and corporate credit environment.

In Europe, net loan impairment charges rose by 10 per cent to US\$2,155 million. In the UK, net charges rose by a modest 4 per cent as growth in the personal customer impairment charge, which was broadly in line with lending growth, was partially offset by favourable movements on the impairment charge for commercial loans in a robust corporate credit environment. The personal sector continued to

experience higher levels of IVA and bankruptcy filings, following an easing of bankruptcy regulations in 2004, growth in consumer indebtedness and a rise in unemployment. This was mitigated by action taken on underwriting and collections. In France, the non-recurrence of several significant recoveries in 2005 resulted in an increase in net loan impairment charges in 2006.

Loan impairment charges in Hong Kong remained low at US\$172 million, underpinned by robust personal and commercial credit quality in a strong economy with low unemployment.

In the Rest of Asia-Pacific, loan impairment charges rose sharply to US\$512 million. Taiwan and Indonesia experienced credit deterioration during 2006, although the problem peaked in the first half of the year. Taiwan was affected by the imposition of a mandatory government debt renegotiation scheme which allowed customers to extend and heavily discount repayment terms, leading to market-wide credit losses. Indonesia was also affected by regulations, specifically with respect to minimum re-payment terms which compounded higher impairments brought about by a reduction in fuel subsidies. Elsewhere in the Rest of Asia-Pacific credit quality was stable.

In North America, the net loan impairment charge increased significantly, by 32 per cent to US\$6,796 million, largely in the second half of 2006, driven by the credit deterioration in US sub-prime mortgages described in the first bullet point above. The effects of the decline in US house price inflation and rising interest rates during 2006 were accentuated by the increased percentage of second lien loan originations to total loans originated in 2005 and the first half of 2006, and the underwriting of stated income (low documentation) products. The US net loan impairment charges increased by 37 per cent after taking into account the most recent trends

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Financial Review

(continued)

Operating expenses

in delinquency and loss severity, projecting the probable impact of re-pricing ARMs, and incorporating the effect of re-pricing on parallel second lien loans. Further details are provided on page 189. Credit delinquency in other parts of the mortgage portfolio and in other US businesses rose modestly, driven by unusually low levels at the end of 2005, and growing loan maturity in 2006. Partially offsetting the effects of credit deterioration were a decline in bankruptcy filings following the surge at the end of 2005, relatively low unemployment and a fall in exposure estimated to result from hurricane Katrina.

In Latin America, the rise in impairment charges by 24 per cent to US\$938 million was largely recorded in Mexico and, to a lesser extent, Brazil and Argentina. In Mexico, strong loan growth, particularly in 2006, led to increased loan impairment charges. In Brazil, the credit weaknesses seen in 2005 and the first half of 2006, particularly in the consumer market, were mitigated by changes to underwriting procedures. Net charges in Brazil increased by 7 per cent compared with 54 per cent in 2005 and declined in the second half of 2006 compared with the first half. In Argentina, net charges rose as a result of the non-recurrence of releases and recoveries in 2005.

The aggregate outstanding customer loan impairment allowances at 31 December 2006 of US\$13,578 million represented 1.6 per cent of gross customer advances (net of reverse repos and settlement accounts), compared with 1.5 per cent at the same time in 2005.

Impaired loans to customers were US\$13,785 million at 31 December 2006 compared with US\$11,446 million at 31 December 2005. On a constant currency basis, impaired loans were 14 per cent higher than in 2005 compared with lending growth (excluding loans to the financial sector and settlement accounts) of 10 per cent.

Year ended 31 December 2005 compared with year ended 31 December 2004

During 2005, the underlying growth in customer lending excluding loans to the financial sector and the impact of grossing adjustments required from 1 January 2005 under IFRSs, was 12 per cent. Personal lending accounted for 63 per cent of this increase, principally in mortgages, credit cards and other personal lending products. At 31 December 2005, personal lending accounted for 56 per cent of the customer loan portfolio, in line with 2004. The proportion of the portfolio attributable to corporate and commercial lending was augmented by the

IFRSs adjustment noted above. Residential mortgages comprised 56 per cent of the personal lending portfolio.

The charge for loan impairment adjusts the balance sheet allowance for loan impairment to the level that management deems adequate to absorb actual and inherent losses in the Group's loan portfolios. The majority of the Group's loan impairment charges were determined on a portfolio basis, employing statistical calculations using roll rate methodologies. The total charge for loan impairment and other credit risk provisions in 2005 was US\$7,801 million compared with a total charge of US\$6,191 million in 2004, a rise of 26 per cent. This reflected:

- underlying growth in lending of 12 per cent;
- a weakening credit environment in the UK and Brazil but an improved credit experience in the US; and
- the non-recurrence of the 2004 net release of general provision of US\$498 million.

In the US, the underlying trend in loan impairment charges was favourable compared with 2004, notwithstanding the negative effect on loan impairment charges of hurricane Katrina and a surge in personal bankruptcies in October ahead of new legislation making such declarations more onerous. This was due to a

change in portfolio mix towards higher quality lending and a positive economic environment.

In the UK, credit costs rose following an expansion in personal lending, which was accompanied by an increase in delinquencies as the economy slowed during 2005. This was evidenced by rising personal bankruptcy, caused in part by legislative changes which facilitated debt reconstruction procedures, an increase in unemployment and higher levels of personal debt. In Hong Kong, the credit environment remained benign, with falling bankruptcies contributing to a modest reduction in loan impairment allowances in the personal sector. A fall in releases in the corporate sector, however, contributed to a modest charge for loan impairment as compared with a net release in 2004. In the Rest of Asia-Pacific, continuing releases and recoveries partly offset the impact of lending growth in the region. Higher charges in the personal sector in Brazil followed intense competitive pressure in the consumer segment, where significant increases in the availability of credit led to customers becoming over-indebted.

The aggregate customer loan impairment allowances at 31 December 2005 of

[Back to Contents](#)

US\$11,357 million represented 1.5 per cent of gross customer advances (net of reverse repos, settlement accounts and netting) compared with 2.0 per cent at 31 December 2004. As in 2004, HSBC's cross-border exposures did not necessitate significant allowances.

Impaired loans to customers were US\$11,446 million at 31 December 2005 compared

with US\$12,427 million at 31 December 2004, largely reflecting the write-off of impaired loans against the provisions held in respect of these loans. At constant exchange rates, impaired loans were 3 per cent lower than 2004 compared with underlying lending growth (excluding lending to the financial sector and settlement accounts) of 12 per cent.

Operating expenses

	Year ended 31 December					
	2006 US\$m	%	2005 US\$m	%	2004 US\$m	%
By geographical region						
Europe	13,871	39.6	12,639	41.4	12,028	44.4
Hong Kong	3,269	9.3	2,867	9.4	2,558	9.4
Rest of Asia-Pacific	3,548	10.1	2,762	9.1	2,087	7.7
North America ¹	10,193	29.1	8,758	28.8	7,915	29.2
Latin America ¹	4,166	11.9	3,426	11.3	2,530	9.3
	35,047	100.0	30,452	100.0	27,118	100.0
Intra-HSBC elimination	(1,494)		(938)		(631)	
Total operating expenses	33,553		29,514		26,487	

	Year ended 31 December		
	2006 US\$m	2005 US\$m	2004 US\$m
By expense category			
Employee compensation and benefits ²	18,500	16,145	14,523
Premises and equipment (excluding depreciation and impairment)	3,389	2,977	2,615
General and administrative expenses	9,434	8,206	7,124
Administrative expenses	31,323	27,328	24,262
Depreciation and impairment of property, plant and equipment	1,514	1,632	1,731
Amortisation and impairment of intangible assets ³	716	554	494
Total operating expenses	33,553	29,514	26,487

	At 31 December		
	2006	2005	2004
Staff numbers (full-time equivalent)			

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Europe	78,311	77,755	74,861
Hong Kong	27,586	25,931	25,552
Rest of Asia-Pacific	72,265	55,577	41,031
North America ¹	55,642	53,608	49,416
Latin America ¹	67,116	55,600	52,473
Total staff numbers	300,920	268,471	243,333

- 1 *In 2006, Mexico and Panama were reclassified from the North America segment to the Latin America segment. Comparative information has been restated accordingly.*
- 2 *A charge of US\$135 million was realised in 2006 arising from the waiver of the TSR-related performance condition in respect of the 2003 awards under the HSBC Holdings Group Share Option Plan (the Plan). As explained in the Annual Report and Accounts 2005, in light of the impressive and sustained performance and shareholder returns over the three years covered by the 2003 awards, the Group Remuneration Committee exercised its discretion, as permitted within the Plan, to waive the TSR performance condition. Under both IFRSs and US GAAP this is treated as a modification which requires an additional accounting charge: this is a non-cash item.*
- 3 *Intangible asset amortisation comprises the expensing through the income statement of purchased intangibles such as mortgage servicing rights and customer/merchant relationships and amounts allocated to intangible assets on the fair valuation of assets within acquired business combinations. This latter category principally includes customer relationships.*

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Financial Review

(continued)

Operating expenses

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

Operating expenses of US\$33,553 million were US\$4,039 million, or 14 per cent, higher than in 2005, and 11 per cent higher on an underlying basis.

The commentary that follows is on an underlying basis.

The main drivers of cost growth were as follows:

- various business expansion initiatives were undertaken during the year. The retail banking operation in the US was enhanced in the form of new branches and improved geographical coverage of Commercial Banking. In the UK, major work was undertaken to refurbish the branch network, improve and increase the number of self-service machines and extend opening hours in certain branches. Across the Rest of the Asia-Pacific region, the branch network expanded, the rollout of the consumer finance business continued, and Commercial Banking's operations were further developed. In Latin America, improvements were made to HSBC's operations in Mexico through the continued expansion of the branch and ATM network;
- the higher costs incurred in Corporate, Investment Banking and Markets reflected the first full year effect of investments made in 2005, together with volume-driven growth in transactional banking and securities services activities and performance-related pay, which rose as revenues grew. The cost efficiency ratio of Corporate, Investment Banking and Markets improved by 40 basis points as net operating income before loan impairment charges grew faster than costs; and
- HSBC's expenditure on marketing continued in order to increase brand awareness, grow market share in key products and support the launch of new products. Notable successes included the online savings product in the US, strong growth in credit card acquisition across the Group, and an innovative new online mortgage product offered in Mexico.

The following points are also of note.

In Europe, the cost growth of 9 per cent was concentrated in Personal Financial Services and Corporate, Investment Banking and Markets. In Personal Financial Services, business expansion across the region drove the expenditure. In the UK, costs rose as the branch network refurbishment

programme proceeded, additional staff were recruited to support longer opening hours in certain branches and IT costs increased. In France and Turkey, costs rose from the recruitment of additional sales staff and higher marketing expenditure. Costs in Corporate, Investment Banking and Markets increased, reflecting higher performance-related staff costs and the full year effect of the investment in 2005 in the business, especially in structured derivatives and Global Transaction Banking, where significant revenue growth was seen. These cost increases were partly offset by a reduction in Commercial Banking expenses following the sale of vehicle finance fleet management activities in the UK.

In Hong Kong, the increase in operating expenses of 14 per cent was mainly due to higher staff and marketing costs. Additional staff recruited to support longer opening hours in the branch network and the expansion of Commercial Banking, and an increase in revenue-driven performance-related awards drove staff costs higher.

Marketing expenditure incurred on advertising and promotional activities rose in support of credit card and investment fund products in Personal Financial Services and the launch of Commercial Banking's global campaign. The full year effect of the enhancement in the second half of 2005 of Corporate, Investment Banking and Markets' business contributed further to the cost growth.

The 27 per cent rise in operating expenses in the Rest of Asia-Pacific region was primarily incurred in supporting retail business expansion. Staff costs rose from increased recruitment to support new business initiatives and incentive payments grew in response to improved revenues. Marketing expenses rose as advertising and promotional activity aimed at enlarging HSBC's market share in cards, mortgages and other unsecured lending grew, and Commercial Banking marketing activity across several countries increased. In Corporate, Investment Banking and Markets, cost growth reflected higher revenue-driven performance-related costs and increased expenditure in Global Transaction Banking necessitated by business volumes.

In North America, costs rose by 13 per cent in 2006. In the US, the increase accompanied the expansion of both the core banking network (by 25 branches) and the geographical presence of Commercial Banking, and arose from incremental costs incurred in support of revenue growth in the consumer finance business. Marketing expenditure also rose, in line with increased levels of activity in the cards businesses in the US, continued promotion of the online savings product and airport branding

[Back to Contents](#)

initiatives. Cost growth in Canada followed higher revenues. The first full year effect of the expansion of various Corporate, Investment Banking and Markets businesses that commenced last year, together with higher performance-linked pay contributed further to the expense growth.

In Latin America, operating expenses rose by 12 per cent. Staff costs grew as additional staff were recruited to support business expansion and pay rises were agreed with the unions. Marketing expenditure was higher as a consequence of advertising campaigns run by Personal Financial Services and Commercial Banking. The continued expansion of the branch network and ATM infrastructure in Mexico, in conjunction with construction of the new headquarters, also contributed to the overall cost growth in the region. Costs rose in Corporate, Investment Banking and Markets in line with higher transactional volumes, increased headcount and union-agreed pay rises.

Year ended 31 December 2005 compared with year ended 31 December 2004

Operating expenses of US\$29,514 million were US\$3,027 million, or 11 per cent, higher than in 2004. On an underlying basis, cost growth was 9 per cent, trailing net operating income growth before impairment charges by 3 percentage points. This resulted in a slight improvement in the cost efficiency ratio to 51 per cent. The three main drivers of cost growth were as follows:

- volume expansion in many markets drove both revenue and costs. In Personal Financial Services and Commercial Banking, business expansion drove cost growth of 6 per cent and 4 per cent respectively, though this was exceeded by growth in net operating income before loan impairment charges of 11 per cent and 15 per cent respectively. In Mexico, Turkey and Brazil, cost increases contributed over half of the overall increase, but were significantly exceeded by income growth;
- HSBC continued to improve productivity in mature markets. In the UK, reorganisations in Personal Financial Services and Commercial Banking in 2004 resulted, in aggregate, in broadly flat costs compared with growth of 10 per cent in net operating income before loan impairment charges. This was delivered through greater utilisation of direct channels, improved training and increased incentives. In Hong Kong, the promotion of cost-efficient delivery channels and greater utilisation of the Group Service Centres contributed to a 6 percentage point improvement in the cost efficiency ratios in Personal Financial Services and Commercial Banking; and
- following a number of senior hires in 2004 in Corporate, Investment Banking and Markets, subsequent investment was focused on operations and technology, to support revenue growth. Non-staff costs increased by 23 per cent in 2005, with staff costs growing by 14 per cent. The rate of cost growth peaked during the year and the cost efficiency ratio was 2 percentage points better in the second half of the year than the first half, as net operating income before loan impairment charges grew faster than costs.

The following points are also of note. In Europe, costs included the rebranding of the Group's operations in France, the refurbishment of 60 UK branches and increased marketing costs. These increases were offset by lower costs in Commercial Banking in the UK following restructuring activity in 2004. Costs in Corporate, Investment Banking and Markets increased by 9 per cent, reflecting increased staff numbers and investments in technology and infrastructure.

In Hong Kong, higher operating expenses reflected business expansion in Corporate, Investment Banking and Markets, supported by increased staff in the investment banking division and the recruitment of senior relationship managers. This was partly offset by the effect of branch restructuring and increased utilisation of the Group Service Centres in Personal Financial Services, which led to a 4 per cent fall in branch headcount.

Underlying operating expenses in the Rest of Asia-Pacific increased by 31 per cent, reflecting investment in broadening the customer base and the distribution platform. HSBC's branch network was extended in mainland

China, South Korea, and India, and additional sales and support staff were recruited in Personal Financial Services and Commercial Banking. Staff numbers also increased in response to the migration of call centre activities to the Group Service Centres in the region. Growth initiatives required investment in infrastructure and technology, and accordingly non-staff costs increased by 39 per cent.

In North America, costs bore a particularly large share of the investment in Corporate, Investment Banking and Markets, reflecting HSBC's commitment to growing its presence in the region. Costs also reflected the expansion of the network, with the opening of 27 new branches in 2005 and the launch of HSBC's online savings account in the US.

[Back to Contents](#)

HSBC HOLDING SPLC

Report of the Directors: Financial Review (continued)*Share of profit in associates and joint ventures*

HSBC's Latin American operations reported a 21 per cent increase in operating expenses on an underlying basis, partly as a result of higher average staff numbers following the acquisition of consumer finance businesses in 2004. Marketing costs rose following a number of high profile campaigns in 2005, while transactional taxes and incentive

payments grew as a direct consequence of higher income.

Productivity improvements and strong disposal gains allowed HSBC to substantially complete its investment in Corporate, Investment Banking and Markets without any deterioration in the Group's cost efficiency ratio.

Cost efficiency ratios

	Year ended 31 December		
	2006 %	2005 %	2004 %
HSBC	51.3	51.2	51.6
Personal Financial Services	49.7	48.7	50.1
Europe	59.2	58.2	57.7
Hong Kong	32.2	33.3	39.2
Rest of Asia-Pacific	71.1	72.3	70.8
North America ¹	42.3	40.8	40.1
Latin America ¹	65.6	64.4	66.2
Commercial Banking	43.7	45.5	50.0
Europe	46.7	49.9	55.2
Hong Kong	26.1	27.2	33.7
Rest of Asia-Pacific	42.5	43.8	42.7
North America ¹	44.9	43.1	46.0
Latin America ¹	55.9	58.2	60.5

¹ In 2006, Mexico and Panama were reclassified from the North America segment to the Latin America segment. Comparative information has been restated accordingly.

HSBC's cost efficiency ratio worsened by 10 basis points. On an underlying basis there was a 20 basis point deterioration.

In Personal Financial Services, there was a 100 basis point deterioration in the cost efficiency ratio as the growth of costs incurred in Europe, North America and Latin America in support of

business expansion exceeded revenue growth. The cost efficiency ratio in Corporate, Investment Banking and Markets improved by 80 basis points to 58.9 per cent as revenues grew 1 per cent faster than costs, and in Commercial Banking by 180 basis points to 43.7 per cent. In Private Banking, the cost efficiency ratio improved from 62 per cent to 57.5 per cent.

**Share of profit in associates
and joint ventures**

	Year ended 31 December					
	2006		2005		2004	
	US\$m	%	US\$m	%	US\$m	%
By geographical region						
Europe	(72)	(8.4)	120	18.6	37	13.8
Hong Kong	19	2.2	23	3.6	23	8.6
Rest of Asia-Pacific	865	102.2	453	70.3	215	80.2
North America ¹	30	3.5	48	7.5	(8)	(3.0)
Latin America ¹	4	0.5	□	□	1	0.4
Share of profit in associates and joint ventures	846	100.0	644	100.0	268	100.0

[Back to Contents](#)

	Year ended 31 December		
	2006 US\$m	2005 US\$m	2004 US\$m
Share of profit in:			
□ associates	823	546	266
□ joint ventures	23	98	2
Share of profit in associates and joint ventures	846	644	268

¹ In 2006, Mexico and Panama were reclassified from the North America segment to the Latin America segment. Comparative information has been restated accordingly.

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

Income from associates and joint ventures was US\$846 million, an increase of 31 per cent compared with 2005, and 7 per cent on an underlying basis.

The commentary that follows is on an underlying basis.

Improved contributions from The Saudi British Bank, Bank of Communications and Industrial Bank were supplemented by a first full year contribution from Ping An Insurance. These strategic investments are of increasing significance to HSBC's operations in the Rest of Asia-Pacific region. The profits were partly offset by a loss arising from an impairment charge on a private equity investment of an associate in Europe.

- In August 2005, HSBC made an additional investment to increase its stake in Ping An Insurance to 19.9 per cent. The associate reported record results for 2006, with steady growth in the core insurance business complemented by strong investment performance following buoyant stock markets.

During 2006, Ping An Insurance group's nationwide back-office operation in Shanghai became fully functional and the centralisation of the life insurance underwriting and claims business was completed.

- HSBC's share of income from Bank of Communications rose by 44 per cent, driven by wider spreads and an improved product mix, with increased corporate and consumer lending. Fee income also rose as significant progress was made in expanding its investment banking operations.

In 2006, effective risk management and cost control drove operating efficiency with an improvement in the cost efficiency ratio, despite a period of business expansion.

- During the second half of 2006, HSBC and The Saudi British Bank jointly established HSBC Saudi Arabia Limited, the first full-service

independent investment bank in Saudi Arabia licensed under the local new Capital Market law. HSBC, through a wholly owned subsidiary, holds 60 per cent of the equity in the new company and The Saudi British Bank, in which HSBC has a 40 per cent shareholding, holds the remaining 40 per cent.

The share of profits from The Saudi British Bank grew by 21 per cent reflecting a strong performance in all core businesses.

Year ended 31 December 2005 compared with year ended 31 December 2004

Income from associates and joint ventures grew significantly to US\$644 million. On an underlying basis, an increase of 72 per cent was driven by strong performance in The Saudi British Bank and gains on the sale of HSBC's indirect stake in MISR International, an Egyptian Bank. These revenue streams were complemented by increased contributions from the bank's strategic investments in mainland China; Bank of Communications and Industrial Bank, interests in which were acquired in 2004, and Ping An Insurance, which became an associate in August 2005.

Bank of Communications is the fifth largest bank in mainland China as measured by assets. HSBC's share of Bank of Communications' profits in 2005 was US\$175 million, significantly higher than those reported in 2004. This largely reflected the first full year of profits in 2005, though Bank of Communications recorded an overall increase on a like-for-like basis, principally as a result of asset and liability growth combined with moderate expansion in operating expenses.

Ping An Insurance is one of mainland China's leading insurance groups focusing on providing life and property and casualty insurance products. In August 2005, HSBC increased its stake in Ping An Insurance to 19.9 per cent, began to account for it as an associate.

The Saudi British Bank is 40 per cent owned by HSBC. HSBC's share of its profits increased by 53 per cent to US\$268 million in 2005, largely

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Financial Review

(continued)

Asset deployment / Funds under management / Assets held in custody

driven by strong investment banking performance, a buoyant stock market and rapid growth in Shariah-compliant products and services.

Asset deployment

	At 31 December			
	2006 US\$m	%	2005 US\$m	%
Loans and advances to customers	868,133	46.6	740,002	49.3
Loans and advances to banks	185,205	10.0	125,965	8.4
Trading assets	328,147	17.6	232,909	15.5
Financial investments	204,806	11.0	182,342	12.1
Derivatives	103,702	5.6	73,928	4.9
Goodwill and intangible assets	37,335	2.0	33,200	2.2
Other	133,430	7.2	113,624	7.6
	1,860,758	100.0	1,501,970	100.0

Loans and advances to customers include:

□ reverse repos	18,755	14,610
□ settlement accounts	3,254	2,142

Loans and advances to banks include:

□ reverse repos	45,019	24,754
□ settlement accounts	2,028	2,669

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

HSBC's total assets at 31 December 2006 were US\$1,861 billion, an increase of US\$359 billion or 24 per cent since 31 December 2005. Two thirds of the increase was driven by balance sheet growth within Corporate, Investment Banking and Markets, the largest component of which was trading assets. Acquisitions added US\$13 billion to total assets. On an underlying basis, total assets grew by 17 per cent. The commentary that follows is on an underlying basis.

At 31 December 2006, HSBC's balance sheet remained highly liquid. The proportion of assets deployed in customer advances fell to 47 per cent, predominantly due to a significant increase in trading assets which, at 31 December 2006, were 2 percentage points higher than in 2005 at US\$328 billion, representing 18 per cent of total assets. The increase of US\$95 billion in trading assets resulted primarily from higher holdings of debt

securities.

Customer advances increased 17 per cent as a result of expansion in mortgages and other personal banking loans. Residential mortgage growth in the first half of 2006 was mainly in the US, though this slowed in the second half as HSBC reduced its exposure to mortgages generated by correspondents and tightened lending criteria. In the second half of the year mortgage increases were strongest in the UK although HSBC saw its market share fall modestly in a buoyant UK housing market. Growth in other personal banking advances in the first half of 2006

was driven by second lien mortgages and unsecured lending in the US and, in the second half of the year, in the UK, notwithstanding tighter underwriting criteria. In France, mortgage lending falling outside of the strict classification of residential mortgages contributed significantly to growth. Growth in corporate lending was mainly in Commercial Banking, with significant increases in lending to the services and energy sectors.

Trading assets and financial investments

Trading assets principally consist of debt and equity instruments acquired for the purpose of market making or to benefit from short-term price movements. Securities classified as held for trading are carried in the balance sheet at fair value with movements in fair value reflected within the income statement.

Trading assets of US\$328 billion at 31 December 2006 were 41 per cent higher than at 31 December 2005. On an underlying basis, the increase was 32 per cent. A 27 per cent rise in debt securities resulted from increased holdings of shorter-maturity assets in the UK and deployment of the increased commercial surplus in Hong Kong. In the US, trading assets rose, reflecting the first full year effect of the residential mortgage-backed securities business following its launch in 2005.

Financial investments include debt and equity instruments that are classified as available for sale or, to a very small extent, held to maturity. Available-for-sale investments essentially represent a core element of the Group's liquidity and may be disposed

[Back to Contents](#)

of either to manage that liquidity or in response to investment opportunities arising from favourable movements in economic indicators, such as interest rates, foreign exchange rates and equity prices. They are carried at fair value with unrealised gains and losses from movements thereon reported in equity until disposal. On disposal the accumulated unrealised gain or loss is recognised through the income statement and reported as [Gains less losses from financial investments].

Financial investments of US\$205 billion at 31 December 2006 were 12 per cent higher than at 31 December 2005 and 8 per cent higher on an underlying basis. This was primarily driven by an increase in holdings of debt securities. HSBC's operations in Europe, reported a rise in the credit risk arbitrage portfolio reflecting strong investor demand for commercial paper while, in Hong Kong, the increase was driven by the deployment of increased commercial surplus. Net unrealised gains in the valuation of equities amounted to US\$2,299 million.

Funds under management

Funds under management at 31 December 2006 were US\$695 billion, an increase of US\$134 billion, or 24 per cent, compared with 31 December 2005. The increase was 16 per cent on an underlying basis. Both Group Investment Businesses and Private Banking delivered good investment performance and strong net new money. HSBC is among the world's largest emerging market asset managers with US\$62 billion of funds under management invested in emerging market assets.

Group Investment Businesses managed

US\$328 billion of assets at 31 December 2006, a rise of 23 per cent compared with 31 December 2005, recording US\$14 billion of net new money and good investment performance.

Private Banking attracted net new money of US\$24 billion, due in part to greater brand awareness and an enhanced product range, which together with good investment performance contributed towards increased funds under management of US\$232 billion at 31 December 2006, 20 per cent higher than at 31 December 2005.

Other funds under management, of which the main constituent was a corporate trust business in Asia, reported funds under management of US\$133 billion at 31 December 2006, an increase of 40 per cent compared with 31 December 2005.

	2006 US\$bn	2005 US\$bn
Funds under management		
At 1 January	561	476
Net new money	44	63
Value change	57	45
Exchange and other	33	(23)
	<hr/>	<hr/>
At 31 December	695	561
	<hr/>	<hr/>
		Year ended 31 December
		<hr/>
	2006 US\$bn	2005 US\$bn
Funds under management by business		
Group Investment Businesses	328	267
Private Banking ¹	232	194
Affiliates	2	5
Other ¹	133	95
	<hr/>	<hr/>
	695	561

¹ 2005 has been restated to transfer US\$8 billion from Private Banking to Other.

Client assets, which provide an indicator of overall Private Banking volumes and include funds under management, cash deposits and certain on-balance sheet trust assets, rose by 22 per cent compared with 31 December 2005 to reach US\$333 billion.

Assets held in custody and under administration

At 31 December 2006, assets held by HSBC as custodian amounted to US\$4,572 billion, 41 per cent higher than the US\$3,242 billion held at 31 December 2005. At constant exchange rates growth was 28 per cent. Custody is the safekeeping and administration of securities and financial instruments on behalf of others.

Complementing this is HSBC's assets under administration business. At 31 December 2006, the value of assets held under administration by the Group amounted to US\$1,150 billion, 48 per cent higher than the US\$779 billion held at 31 December 2005. At constant exchange rates, growth was 37 per cent.

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Financial Review

(continued)

*Economic profit / Other financial information***Economic profit**

HSBC's internal performance measures include economic profit, a calculation which compares the return on financial capital invested in HSBC by its shareholders with the cost of that capital. HSBC prices its cost of capital internally and the difference between that cost and post-tax profit attributable to ordinary shareholders represents the amount of economic profit generated. Economic profit is used by management as a means of deciding where to allocate resources so that they will be most productive.

In order to concentrate on external factors rather than measurement bases, HSBC emphasises the trend in economic profit within business units rather than absolute amounts. In light of the current levels of

world interest rates, and taking into account its geographical and customer group diversification, HSBC believes that its true cost of capital on a consolidated basis remains 10 per cent. HSBC plans to continue using this rate until the end of the current five-year strategic plan in 2008 in order to ensure consistency and comparability.

Economic profit decreased by US\$418 million, or 7 per cent compared with 2005. The rate of growth in profit attributable was slower than the growth in average shareholders' equity, mainly due to increased loan impairment charges in the US mortgage service business. This was also reflected in a lower return on average invested capital and in consequence economic spread, which fell by 1 percentage point compared with 2005.

	Year ended 31 December			
	2006 US\$m	%1	2005 US\$m	%1
Average total shareholders' equity	100,860		89,589	
Add: Goodwill previously amortised or written off	8,172		8,172	
Less: Property revaluation reserves	(1,062)		(1,092)	
Reserves representing unrealised gains on effective cash flow hedges	(126)		(315)	
Reserves representing unrealised gains on available-for-sale securities	(1,156)		(1,294)	
Preference shares	(1,405)		(351)	
Average invested capital ²	105,283		94,709	
Return on invested capital ³	15,699	14.9	15,060	15.9
Benchmark cost of capital	(10,528)	(10.0)	(9,471)	(10.0)
Economic profit/spread	5,171	4.9	5,589	5.9

1 Expressed as a percentage of average invested capital.

- 2 *Average invested capital is measured as average total shareholders' equity after:*
- adding back the average balance of goodwill impaired or amortised pre transition to IFRS or subsequent written-off, directly to reserves;*
 - deducting the average balance of HSBC's revaluation surplus relating to property held for own use. This reserve was generated when determining the deemed carrying cost of such properties on transition to IFRS and will run down over time as the properties are sold;*
 - deducting average preference shares issued by HSBC Holdings, and;*
 - deducting average reserves for unrealised gains/(losses) on effective cash flow hedges and available-for-sale securities.*
- 3 *Return on invested capital is based on the profit attributable to ordinary shareholders of the parent company.*

[Back to Contents](#)

Other financial information

Average balance sheet and net interest income

Average balances and the related interest are shown for the domestic operations of HSBC's principal commercial banks by geographic region with all other commercial banking and investment banking balances and transactions included in "Other operations".

Net interest margin numbers are calculated by dividing net interest income as reported in the income statement by the average interest earning assets from which interest income is reported within the "Net interest income" line of the income statement. Interest income and interest expense arising from trading assets and liabilities and the funding thereof is included within "Net trading income" in the income statement.

Assets		Year ended 31 December								
		2006			2005			2004		
		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										
Europe	HSBC Bank	33,856	1,536	4.54	21,875	774	3.54	24,173	669	2.77
	HSBC Private Banking Holdings (Suisse)	4,956	190	3.83	3,606	113	3.13	2,644	89	3.37
	HSBC France	20,197	690	3.42	16,829	387	2.30	26,007	960	3.69
Hong Kong	Hang Seng Bank	10,360	483	4.66	8,061	288	3.57	8,328	221	2.65
	The Hongkong and Shanghai Banking Corporation	38,802	1,645	4.24	36,904	1,058	2.87	28,172	538	1.91
	The Hongkong and Shanghai Banking Corporation	13,388	520	3.88	11,667	351	3.01	9,180	198	2.16
Rest of Asia-Pacific	HSBC Bank Malaysia	2,492	87	3.49	1,767	49	2.77	1,348	36	2.67
	HSBC Bank Middle East .	4,279	208	4.86	3,262	111	3.40	1,619	29	1.79
North America	HSBC Bank USA	8,422	465	5.52	3,579	151	4.22	2,323	56	2.41
	HSBC Bank Canada	3,167	138	4.36	2,115	62	2.93	2,163	45	2.08
Latin America	HSBC Mexico Brazilian operations ¹	3,395	227	6.69	2,994	228	7.62	3,771	227	6.02
	HSBC Bank Argentina	4,129	572	13.85	3,305	565	17.10	1,954	237	12.13
		196	8	4.08	264	7	2.65	250	3	1.20
Other operations		16,816	627	3.73	15,023	456	3.04	19,515	329	1.69
		164,455	7,396	4.50	131,251	4,600	3.50	131,447	3,637	2.77

**Trading
assets²**

Europe	HSBC Bank	29,183	1,147	3.93
	HSBC France	13,663	365	2.67
Hong Kong	Hang Seng Bank	369	13	3.52
	The Hongkong and Shanghai Banking Corporation	11,209	298	2.66
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	2,487	101	4.06
	HSBC Bank Malaysia	145	4	2.76
North America	HSBC Bank USA	5,447	115	2.11
	HSBC Bank Canada	1,177	25	2.12
	HSBC Markets Inc	11,543	421	3.65
Latin America	HSBC Mexico	2,957	173	5.86
	Brazilian operations ¹	843	128	15.18
	HSBC Bank Argentina	19	1	5.26
Other operations		5,661	232	4.10
		<u>84,703</u>	<u>3,023</u>	<u>3.57</u>

For footnotes, see page 156.

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Financial Review

(continued)

*Other financial information > Average balance sheet*Assets
(continued)

		Year ended 31 December								
		2006			2005			2004		
		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 %
Loans and advances to customers										
Europe	HSBC Bank	226,528	14,166	6.25	203,568	12,223	6.00	170,939	9,521	5.57
	HSBC Private Banking Holdings (Suisse)	7,134	338	4.74	5,795	211	3.64	4,700	115	2.45
	HSBC France	52,990	2,463	4.65	41,977	1,710	4.07	42,149	1,892	4.49
	HSBC Finance	5,932	671	11.31	9,951	1,086	10.91	9,276	1,055	11.37
Hong Kong	Hang Seng Bank	34,416	1,952	5.67	32,893	1,323	4.02	31,234	882	2.82
	The Hongkong and Shanghai Banking Corporation	47,292	2,843	6.01	43,971	2,061	4.69	41,901	1,406	3.36
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	52,159	3,449	6.61	46,652	2,659	5.70	36,775	1,781	4.84
	HSBC Bank Malaysia	6,292	430	6.83	5,380	325	6.04	4,937	278	5.63
	HSBC Bank Middle East	12,757	957	7.50	10,038	635	6.33	7,425	418	5.63
North America	HSBC Bank USA	88,563	6,141	6.93	86,800	5,594	6.44	61,659	2,936	4.76
	HSBC Finance	147,336	17,061	11.58	118,215	13,307	11.26	114,393	13,146	11.49
	HSBC Bank Canada	35,055	2,037	5.81	28,491	1,439	5.05	22,603	1,099	4.86
Latin America	HSBC Mexico	13,193	1,532	11.61	9,983	1,210	12.12	8,095	878	10.85
	Brazilian operations ¹	9,461	3,244	34.29	7,447	2,647	35.54	4,726	1,527	32.31
	HSBC Bank Argentina	838	107	12.77	914	122	13.35	903	101	11.18
Other operations		20,984	1,620	7.72	27,203	1,352	4.97	35,713	1,113	3.12
		760,930	59,011	7.76	679,278	47,904	7.05	597,428	38,148	6.39
Financial investments										
Europe	HSBC Bank	42,726	1,977	4.63	35,787	1,297	3.62	22,488	824	3.66

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	HSBC Private Banking Holdings (Suisse)	8,729	391	4.48	8,725	342	3.92	10,828	303	2.80
	HSBC France	2,545	95	3.73	4,482	143	3.19	6,957	240	3.45
Hong Kong	Hang Seng Bank	27,288	1,224	4.49	23,445	815	3.48	20,924	507	2.42
	The Hongkong and Shanghai Banking Corporation	20,362	911	4.47	29,508	924	3.13	33,798	779	2.30
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	17,179	737	4.29	15,100	592	3.92	15,902	537	3.38
	HSBC Bank Malaysia	954	36	3.77	1,182	41	3.47	1,156	40	3.46
	HSBC Bank Middle East .	1,387	72	5.19	1,311	44	3.36	1,104	27	2.45
North America	HSBC Bank USA	22,214	1,109	4.99	19,262	864	4.49	18,213	884	4.85
	HSBC Finance	3,724	200	5.37	3,945	221	5.60	4,153	166	4.00
	HSBC Bank Canada	4,351	174	4.00	3,951	116	2.94	2,814	65	2.31
Latin America	HSBC Mexico	4,049	427	10.55	4,995	583	11.67	3,822	395	10.33
	Brazilian operations ¹	3,862	501	12.97	2,328	324	13.92	843	128	15.18
	HSBC Bank Argentina	311	38	12.22	218	23	10.55	169	12	7.10
Other operations		25,171	1,212	4.82	17,769	881	4.96	17,485	564	3.23
		184,852	9,104	4.93	172,008	7,210	4.19	160,656	5,471	3.41

For footnotes, see page 156.

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[Back to Contents](#)

Year ended 31 December

		2006			2005			2004		
		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 %
Other interest-earning assets										
Europe	HSBC Bank	9,938	652	6.56	14,748	543	3.68	8,629	361	4.18
	HSBC Private Banking Holdings (Suisse)	14,558	732	5.03	11,831	416	3.52	7,611	146	1.92
	HSBC France	6,434	173	2.69	9,811	442	4.51	7,533	62	0.82
Hong Kong	Hang Seng Bank	538	28	5.20	81	3	3.70	813	17	2.09
	The Hongkong and Shanghai Banking Corporation	19,246	909	4.72	18,310	443	2.42	16,926	316	1.87
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	6,938	449	6.47	4,836	200	4.14	4,757	179	3.76
	HSBC Bank Malaysia	178	10	5.62	283	8	2.83	153	3	1.96
	HSBC Bank Middle East	380	32	8.42	371	18	4.85	164	10	6.10
North America	HSBC Bank USA	1,867	82	4.39	1,444	43	2.98	784	26	3.32
	HSBC Finance	767	43	5.61	2,063	67	3.25	651	64	9.83
	HSBC Bank Canada	1,006	32	3.18	641	18	2.81	233	8	3.43
Latin America	HSBC Mexico	□	□	□	1,186	16	1.35	336	5	1.49
	Brazilian operations ¹	1,004	190	18.92	558	162	29.03	284	36	12.68
	HSBC Bank Argentina	23	3	13.04	43	2	4.65	30	□	□
Other operations		(59,710)	(2,967)		(49,322)	(2,001)		(46,751)	(1,040)	
		3,167	368	11.62	16,884	380	2.25	2,153	193	8.96
Total interest-earning assets										
Europe	HSBC Bank	313,048	18,331	5.86	275,977	14,837	5.38	255,412	12,522	4.90
	HSBC Private Banking Holdings	35,377	1,651	4.67	29,957	1,082	3.61	25,783	653	2.53

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	(Suisse)									
	HSBC									
	France	82,166	3,421	4.16	73,099	2,682	3.67	96,310	3,520	3.65
	HSBC									
	Finance	5,932	671	11.31	10,553	1,081	10.24	9,342	1,074	11.50
Hong Kong	Hang Seng Bank	72,602	3,687	5.08	64,958	2,447	3.77	61,669	1,614	2.62
	The Hongkong and Shanghai Banking Corporation	125,702	6,308	5.02	128,693	4,485	3.49	132,007	3,337	2.53
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	89,664	5,156	5.75	78,255	3,802	4.86	69,102	2,796	4.05
	HSBC Bank Malaysia	9,916	563	5.68	8,612	423	4.91	7,739	361	4.66
	HSBC Bank Middle East	18,803	1,269	6.75	14,982	808	5.39	10,348	485	4.69
North America	HSBC Bank USA	121,066	7,797	6.44	111,085	6,652	5.99	88,426	4,017	4.54
	HSBC Finance	151,827	17,304	11.40	124,223	13,595	10.94	119,197	13,376	11.22
	HSBC Bank Canada	43,579	2,381	5.46	35,198	1,635	4.65	28,990	1,242	4.28
Latin America	HSBC Mexico	20,637	2,186	10.59	19,159	2,038	10.64	18,982	1,678	8.84
	Brazilian operations ¹	18,456	4,507	24.42	13,637	3,697	27.11	9,186	2,231	24.29
	HSBC Bank Argentina	1,368	156	11.40	1,440	154	10.69	1,371	117	8.53
Other operations		3,261	492	15.06	9,593	676	7.05	42,523	1,449	3.41
		1,113,404	75,879	6.82	999,421	60,094	6.01	976,387	50,472	5.17
Summary										
	Total interest-margin assets	1,113,404	75,879	6.82	999,421	60,094	6.01	976,387	50,472	5.17
	Trading assets ²	288,605	12,445	4.31	292,404	7,232	2.47			
	Financial assets designated at fair value ³	7,681	290	3.78	15,247	405	2.66			
	Impairment provisions	(11,864)			(12,469)			(12,958)		
	Non-interest-earning assets	291,741			207,337			285,912		
	Total assets and interest income	1,689,567	88,614	5.24	1,501,940	67,731	4.51	1,249,341	50,472	4.04

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Financial Review

(continued)

Other financial information > Average balance sheet

Assets (continued)

		Year ended 31 December		
		2006	2005	2004
		%	%	%
Distribution of average total assets				
Europe	HSBC Bank	30.6	30.1	28.3
	HSBC Private Banking Holdings (Suisse)	2.3	2.2	2.2
	HSBC France	10.0	9.9	9.8
	HSBC Finance	0.5	0.7	0.9
Hong Kong	Hang Seng Bank	4.3	4.8	5.2
	The Hongkong and Shanghai Banking Corporation	10.7	12.7	14.2
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	6.0	6.5	6.6
	HSBC Bank Malaysia	0.6	0.6	0.7
	HSBC Bank Middle East	1.3	1.1	0.9
North America	HSBC Bank USA	11.3	10.7	8.8
	HSBC Finance	10.0	9.3	10.8
	HSBC Bank Canada	2.4	2.6	2.4
Latin America	HSBC Mexico	1.7	1.6	1.8
	Brazilian operations ¹	1.5	1.4	0.9
	HSBC Bank Argentina	0.1	0.1	0.1
Other operations (including consolidation adjustments)		6.7	5.7	6.4
		100.0	100.0	100.0

For footnotes, see page 156.

[Back to Contents](#)

Total equity and liabilities

Year ended 31 December

		2006			2005			2004		
		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 banks⁴										
Europe	HSBC Bank	32,825	1,311	3.99	32,673	1,037	3.17	26,950	412	1.53
	HSBC Private Banking Holdings (Suisse)	1,030	33	3.20	886	20	2.26	1,446	27	1.87
	HSBC France	23,171	886	3.82	17,935	582	3.25	22,162	526	2.37
Hong Kong	Hang Seng Bank	2,031	84	4.14	1,876	61	3.25	685	14	2.04
	The Hongkong and Shanghai Banking Corporation	2,745	125	4.55	3,430	116	3.38	3,139	39	1.24
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	6,276	246	3.92	4,973	168	3.38	3,505	95	2.71
	HSBC Bank Malaysia	280	9	3.21	238	5	2.10	98	2	2.04
	HSBC Bank Middle East	453	23	5.08	888	27	3.04	1,104	23	2.08
North America	HSBC Bank USA	3,695	208	5.63	4,251	202	4.75	3,833	74	1.93
	HSBC Bank Canada	1,520	68	4.47	926	34	3.67	392	8	2.04
Latin America	HSBC Mexico	781	50	6.40	1,051	70	6.66	914	48	5.25
	Brazilian operations ¹	1,033	101	9.78	1,355	125	9.23	914	57	6.24
	HSBC Bank Argentina	72	5	6.94	111	8	7.21	140	8	5.71
Other operations		5,653	351	6.24	3,962	211	5.33	11,182	206	1.84
		81,565	3,500	4.29	74,555	2,666	3.58	76,464	1,539	2.01
Customer accounts⁵										
Europe	HSBC Bank	221,369	7,031	3.18	186,996	5,359	2.87	169,501	3,986	2.35
	HSBC Private Banking Holdings (Suisse)	25,346	1,069	4.22	19,908	622	3.12	17,339	377	2.17
	HSBC France	23,579	752	3.19	24,538	611	2.49	22,072	575	2.61
Hong Kong	Hang Seng Bank	54,267	1,712	3.15	51,460	874	1.70	50,944	290	0.57
	The Hongkong and									

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	Shanghai Banking Corporation	104,441	2,934	2.81	95,496	1,322	1.38	92,579	392	0.42
Rest of	The Hongkong and Shanghai Banking Corporation	56,760	1,903	3.35	48,997	1,293	2.64	42,625	891	2.09
Asia-Pacific	HSBC Bank Malaysia	7,260	212	2.92	6,123	157	2.56	5,744	151	2.63
	HSBC Bank Middle East .	11,713	411	3.51	8,696	207	2.38	5,978	60	1.00
North America	HSBC Bank USA	71,031	2,490	3.51	60,795	1,385	2.28	52,813	680	1.29
	HSBC Bank Canada	25,277	804	3.18	21,635	475	2.20	18,191	351	1.93
Latin America	HSBC Mexico operations ¹	13,625	471	3.46	8,272	188	2.27	11,157	377	3.38
	HSBC Bank Argentina	983	41	4.17	903	28	3.10	898	27	3.01
Other operations		50,844	1,845	3.63	44,816	1,273	2.84	56,494	918	1.62
		681,382	23,731	3.48	589,425	15,653	2.66	552,122	9,917	1.80

For footnotes, see page 156.

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Financial Review

(continued)

Other financial information > Average balance sheet

Total equity and liabilities (continued)

		Year ended 31 December								
		2006			2005			2004		
		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 %
Financial liabilities designated at fair value □ own debt issued⁶										
Europe	HSBC Holdings	15,132	745	4.92	13,928	496	3.56			
	HSBC Bank	7,888	373	4.73	5,919	327	5.52			
North America	HSBC Bank USA	1,892	116	6.13	1,469	96	6.54			
	HSBC Finance	29,917	1,877	6.27	28,146	1,098	3.90			
Other operations		461	49	10.63	288	20	6.94			
		55,290	3,160	5.72	49,750	2,037	4.09			
Debt securities in issue										
Europe	HSBC Bank	45,870	2,047	4.46	28,620	1,817	6.35	26,320	1,103	4.19
	HSBC France	19,818	633	3.19	14,271	314	2.20	16,250	434	2.67
	HSBC Finance	548	32	5.84	3,330	77	2.31	3,524	163	4.63
Hong Kong	Hang Seng Bank	1,622	64	3.95	1,523	53	3.48	1,266	30	2.37
	The Hongkong and Shanghai Banking Corporation	□	□	□	□	□	□	11,192	437	3.90
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	7,990	438	5.48	6,523	315	4.83	5,313	229	4.31
		371	13	3.50	572	16	2.80	261	8	3.07

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	HSBC Bank Malaysia									
North America	HSBC Bank USA	28,832	1,407	4.88	25,537	1,073	4.20	11,125	376	3.38
	HSBC Finance	112,353	5,047	4.49	75,913	3,399	4.48	101,269	2,751	2.72
	HSBC Bank Canada	10,616	460	4.33	7,963	268	3.37	5,994	165	2.75
Latin America	HSBC Mexico	249	23	9.24	4,585	285	6.22	3,566	134	3.76
	Brazilian operations ¹	700	70	10.00	401	67	16.71	360	65	18.06
	HSBC Bank Argentina	□	□	□	7	1	14.29	95	7	7.37
Other operations		3,105	110	3.54	6,834	90	1.32	18,136	234	1.29
		<u>232,074</u>	<u>10,344</u>	<u>4.46</u>	<u>176,079</u>	<u>7,775</u>	<u>4.42</u>	<u>204,671</u>	<u>6,136</u>	<u>3.00</u>
Other interest-bearing liabilities										
Europe	HSBC Bank	23,196	1,026	4.42	23,924	547	2.29	30,504	870	2.85
	HSBC Private Banking Holdings (Suisse)	3,545	155	4.37	4,247	130	3.06	2,505	38	1.52
	HSBC France	13,476	488	3.62	14,154	220	1.55	20,117	601	2.99
	HSBC Finance	4,211	219	5.20	5,299	361	6.81	4,298	258	6.00
Hong Kong	Hang Seng Bank	1,378	64	4.64	1,228	36	2.93	1,161	22	1.89
	The Hongkong and Shanghai Banking Corporation	8,140	365	4.48	6,981	221	3.17	10,495	171	1.63
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	13,425	629	4.69	13,725	460	3.35	12,972	228	1.76
	HSBC Bank Malaysia	235	9	3.83	137	4	2.92	195	3	1.54
	HSBC Bank Middle East	1,046	63	6.02	767	23	3.00	407	20	4.91
North America	HSBC Bank USA	11,966	1,211	10.12	13,287	1,332	10.02	12,618	324	2.57
	HSBC Bank Canada	1,134	22	1.94	856	12	1.40	938	20	2.13
	HSBC Markets Inc	2,883	88	3.05	4,718	121	2.56	12,652	460	3.64
Latin America	HSBC Mexico	135	8	5.93	1,258	30	2.38	195	15	7.69
	Brazilian operations ¹	817	105	12.85	2,264	86	3.80	565	47	8.32

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	HSBC Bank Argentina	79	10	12.66	35	4	11.43	319	3	0.94
Other operations		(68,331)	(3,804)		(62,593)	(2,958)		(64,040)	(1,301)	
		17,335	658	3.80	30,287	629	2.08	45,901	1,779	3.88

*For footnotes, see page
156.*

[Back to Contents](#)

Year ended 31 December

		2006			2005			2004		
		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 %
Total interest-bearing liabilities										
Europe	HSBC Bank	331,148	11,788	3.56	278,131	9,087	3.27	253,275	6,371	2.52
	HSBC Private Banking Holdings (Suisse)	29,921	1,257	4.20	25,041	772	3.08	21,290	442	2.08
	HSBC France	80,044	2,759	3.45	71,115	1,732	2.44	80,601	2,136	2.65
	HSBC Finance	4,759	251	5.27	8,667	470	5.42	8,152	421	5.16
Hong Kong	Hang Seng Bank	59,298	1,924	3.24	56,087	1,024	1.83	54,056	357	0.66
	The Hongkong and Shanghai Banking Corporation	115,326	3,424	2.97	105,907	1,659	1.57	117,404	1,038	0.88
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	84,451	3,216	3.81	74,218	2,236	3.01	64,415	1,443	2.24
	HSBC Bank Malaysia	8,146	243	2.98	7,070	182	2.57	6,298	163	2.59
	HSBC Bank Middle East	13,212	497	3.76	10,351	289	2.79	7,489	103	1.38
North America	HSBC Bank USA	117,416	5,432	4.63	105,339	4,088	3.88	80,389	1,454	1.81
	HSBC Finance	142,270	6,924	4.87	116,164	4,933	4.25	112,973	2,964	2.62
	HSBC Bank Canada	38,547	1,354	3.51	31,380	789	2.51	25,516	544	2.13
	HSBC Markets Inc	2,883	88	3.05	4,718	121	2.56	28,563	701	2.45
Latin America	HSBC Mexico	14,790	552	3.73	15,165	573	3.78	15,832	574	3.63
	Brazilian operations ¹	17,437	2,332	13.37	14,810	2,137	14.43	7,626	1,010	13.24
	HSBC Bank Argentina	1,134	56	4.94	1,056	41	3.88	1,453	46	3.17
Other operations		6,864	(703)		(17,224)	(1,373)		(6,174)	(396)	
		1,067,646	41,393	3.88	907,995	28,760	3.17	879,158	19,371	2.20

Summary

Total interest-margin liabilities	1,067,646	41,393	3.88	907,995	28,760	3.17	879,158	19,371	2.20
Trading liabilities	224,050	9,842	4.39	211,059	5,024	2.38			
Financial liabilities designated at fair value (excluding own debt issued)	12,537			9,787					
Non-interest-bearing current accounts	71,744			65,509			56,043		
Total equity and other non-interest-bearing liabilities	313,590			307,590			314,140		
Total equity and liabilities	1,689,567	51,235	3.03	1,501,940	33,784	2.25	1,249,341	19,371	1.55

Net interest margin

		Year ended 31 December		
		2006	2005	2004
		%	%	%
Europe	HSBC Bank	2.09	2.08	2.41
	HSBC Private Banking Holdings (Suisse)	1.15	1.03	0.82
	HSBC France	0.80	1.30	1.44
	HSBC Finance	5.92	5.79	6.99
Hong Kong	Hang Seng Bank	2.43	2.19	2.08
	The Hongkong and Shanghai Banking Corporation	2.29	2.20	1.74
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	2.16	2.00	1.96
	HSBC Bank Malaysia	3.22	2.80	2.56
	HSBC Bank Middle East	3.76	3.46	3.69
North America	HSBC Bank USA	1.95	2.31	2.90
	HSBC Finance	6.84	6.97	8.74
	HSBC Bank Canada	2.36	2.40	2.41
Latin America	HSBC Mexico	7.92	7.65	5.82
	Brazilian operations ¹	11.78	11.44	13.29
	HSBC Bank Argentina	7.24	7.87	5.18
Other operations (including consolidation adjustments)		0.04	0.20	0.03
		3.10	3.14	3.19

For footnotes, see page 156.

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Financial Review**(continued)***Other financial information > Average balance sheet***Analysis of changes in net interest income**

The following table allocates changes in net interest income between volume and rate for 2006 compared with 2005, and for 2005 compared with 2004.

Changes due to a combination of volume and rate, and the effect of reclassifying items on the adoption of IAS 32 and IAS 39 at 1 January 2005, are allocated to rate.

Interest income

		2006 compared with 2005			2005 compared with 2004			
		Increase/(decrease)			Increase/(decrease)			
		2006	Volume	Rate	2005	Volume	Rate	2004
		US\$m	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m
Short-term funds and loans and advances to banks								
Europe	HSBC Bank	1,536	425	337	774	(64)	169	669
	HSBC Private Banking Holdings (Suisse)	190	42	35	113	32	(8)	89
	HSBC France	690	77	226	387	(339)	(234)	960
Hong Kong	Hang Seng Bank	483	82	113	288	(7)	74	221
	The Hongkong and Shanghai Banking Corporation	1,645	54	533	1,058	167	353	538
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	520	52	117	351	54	99	198
	HSBC Bank Malaysia	87	20	18	49	11	2	36
	HSBC Bank Middle East	208	35	62	111	29	53	29
North America	HSBC Bank USA	465	204	110	151	30	65	56
	HSBC Bank Canada	138	31	45	62	(1)	18	45
Latin America	HSBC Mexico	227	31	(32)	228	(47)	48	227
	Brazilian operations ¹	572	141	(134)	565	164	164	237
	HSBC Bank Argentina	8	(2)	3	7	□	4	3
Other operations		627	55	116	456	(76)	203	329

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		7,396	1,162	1,634	4,600	(5)	968	3,637
Trading assets								3,023
Loans and advances to customers								
Europe	HSBC Bank	14,166	1,378	565	12,223	1,817	885	9,521
	HSBC Private Banking Holdings (Suisse)	338	49	78	211	27	69	115
	HSBC France	2,463	449	304	1,710	(8)	(174)	1,892
	HSBC Finance	671	(438)	23	1,086	77	(46)	1,055
Hong Kong	Hang Seng Bank	1,952	61	568	1,323	47	394	882
	The Hongkong and Shanghai Banking Corporation	2,843	156	626	2,061	70	585	1,406
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	3,449	314	476	2,659	478	400	1,781
	HSBC Bank Malaysia	430	55	50	325	25	22	278
	HSBC Bank Middle East	957	172	150	635	147	70	418
North America	HSBC Bank USA	6,141	114	433	5,594	1,197	1,461	2,936
	HSBC Finance	17,061	3,278	476	13,307	439	(278)	13,146
	HSBC Bank Canada	2,037	331	267	1,439	286	54	1,099
Latin America	HSBC Mexico	1,532	389	(67)	1,210	205	127	878
	Brazilian operations ¹	3,244	716	(119)	2,647	879	241	1,527
	HSBC Bank Argentina	107	(10)	(5)	122	1	20	101
Other operations		1,620	(309)	577	1,352	(266)	505	1,113
		59,011	5,756	5,351	47,904	5,230	4,526	38,148

For footnotes, see page 156.

[Back to Contents](#)

		2006 compared with 2005 Increase/(decrease)			2005 compared with 2004 Increase/(decrease)			
		2006 US\$m	Volume US\$m	Rate US\$m	2005 US\$m	Volume US\$m	Rate US\$m	2004 US\$m
Financial investments								
Europe	HSBC Bank	1,977	251	429	1,297	487	(14)	824
	HSBC Private Banking Holdings (Suisse)	391	0	49	342	(59)	98	303
	HSBC France	95	(62)	14	143	(85)	(12)	240
Hong Kong	Hang Seng Bank	1,224	134	275	815	61	247	507
	The Hongkong and Shanghai Banking Corporation	911	(286)	273	924	(99)	244	779
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	737	81	64	592	(27)	82	537
	HSBC Bank Malaysia	36	(8)	3	41	1	□	40
	HSBC Bank Middle East	72	3	25	44	5	12	27
North America	HSBC Bank USA	1,109	133	112	864	51	(71)	884
	HSBC Finance	200	(12)	(9)	221	(8)	63	166
	HSBC Bank Canada	174	12	46	116	26	25	65
Latin America	HSBC Mexico	427	(110)	(46)	583	121	67	395
	Brazilian operations ¹	501	214	(37)	324	225	(29)	128
	HSBC Bank Argentina	38	10	5	23	3	8	12
Other operations		1,212	367	(36)	881	9	308	564
		9,104	538	1,356	7,210	387	1,352	5,471
Deposits by banks								
Europe	HSBC Bank	1,311	5	269	1,037	87	538	412
	HSBC Private Banking Holdings (Suisse)	33	3	10	20	(10)	3	27
	HSBC France	886	170	134	582	(100)	156	526
Hong Kong	Hang Seng Bank	84	5	18	61	24	23	14
	The Hongkong and Shanghai Banking Corporation	125	(23)	32	116	4	73	39
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	246	44	34	168	40	33	95
	HSBC Bank Malaysia	9	1	3	5	3	□	2
	HSBC Bank Middle East	23	(13)	9	27	(5)	9	23
North America	HSBC Bank USA	208	(26)	32	202	8	120	74
	HSBC Bank Canada	68	22	12	34	11	15	8
Latin America	HSBC Mexico	50	(18)	(2)	70	7	15	48
	Brazilian operations ¹	101	(30)	6	125	28	40	57
	HSBC Bank Argentina	5	(3)	□	8	(2)	2	8
Other operations		351	90	50	211	(133)	138	206
		3,500	251	583	2,666	(38)	1,165	1,539

For footnotes, see page 156.

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Financial Review

(continued)

Other financial information > Changes in net interest income / Share capital and reserves

Interest expense

		2006 compared with 2005			2005 compared with 2004			
		Increase/(decrease)			Increase/(decrease)			
		2006	Volume	Rate	2005	Volume	Rate	2004
		US\$m	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m
Customer accounts								
Europe	HSBC Bank	7,031	987	685	5,359	411	962	3,986
	HSBC Private Banking Holdings (Suisse)	1,069	170	277	622	56	189	377
	HSBC France	752	(24)	165	611	64	(28)	575
Hong Kong	Hang Seng Bank	1,712	48	790	874	3	581	290
	The Hongkong and Shanghai Banking Corporation	2,934	123	1,489	1,322	12	918	392
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	1,903	205	405	1,293	133	269	891
	HSBC Bank Malaysia	212	29	26	157	10	(4)	151
	HSBC Bank Middle East	411	72	132	207	27	120	60
North America	HSBC Bank USA	2,490	233	872	1,385	103	602	680
	HSBC Bank Canada	804	80	249	475	66	58	351
Latin America	HSBC Mexico	471	122	161	188	(97)	(92)	377
	Brazilian operations ¹	2,056	706	(509)	1,859	728	289	842
	HSBC Bank Argentina	41	2	11	28	□	1	27
Other operations		1,845	171	401	1,273	(190)	545	918
		23,731	2,442	5,636	15,653	670	5,066	9,917
Financial liabilities designated at fair value [own debt issued]		3,160	227	896	2,037			
Debt securities in issue								
Europe	HSBC Bank	2,047	1,095	(865)	1,817	96	618	1,103
	HSBC France	633	122	197	314	(53)	(67)	434
	HSBC Finance	32	(64)	19	77	(9)	(77)	163
Hong Kong	Hang Seng Bank	64	3	8	53	6	17	30
	The Hongkong and Shanghai Banking Corporation	□	□	□	□	(437)	□	437
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	438	71	52	315	52	34	229
	HSBC Bank Malaysia	13	(6)	3	16	10	(2)	8
North America	HSBC Bank USA	1,407	138	196	1,073	487	210	376
	HSBC Finance	5,047	1,633	15	3,399	(689)	1,337	2,751

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Latin America	HSBC Bank Canada	460	89	103	268	54	49	165
	HSBC Mexico	23	(270)	8	285	38	113	134
	Brazilian operations ¹	70	50	(47)	67	7	(5)	65
	HSBC Bank Argentina	□	(1)	□	1	(6)	□	7
Other operations		110	(49)	69	90	(146)	2	234
		10,344	2,508	61	7,775	(857)	2,496	6,136

Footnotes to □Average balance sheet and net interest income□ and □Analysis of changes in net interest income□.

- 1 *Brazilian operations comprise HSBC Bank Brasil S.A.-Banco Múltiplo and subsidiaries, plus HSBC Serviços e Participações Limitada.*
- 2 *Interest income on trading assets is reported as □Net trading income□ in the consolidated income statement in 2005 and 2006.*
- 3 *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.*
- 4 *This table analyses interest-bearing bank deposits only. See page 160 for an analysis of all bank deposits.*
- 5 *This table analyses interest-bearing customer accounts only. See page 161 for an analysis of all customer accounts.*
- 6 *Interest expense on financial liabilities designated at fair value is reported as □Net income on financial liabilities designated at fair value□ in the consolidated income statement other than interest on own debt.*

[Back to Contents](#)

Notes

- (i) *Average balances are based on daily averages for the principal areas of HSBC's banking activities with monthly or less frequent averages used elsewhere.*
- (ii) *In 2004 [Loans accounted for on a non-accrual basis] and [Loans on which interest has been accrued but suspended] were included in [Loans and advances to banks] and [Loans and advances to customers]. Interest income on such loans was included in the consolidated income statement to the extent to which it had been received.*
- (iii) *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.*
- (iv) *Other than as noted in (iii) above, [Other operations] comprise the operations of the principal commercial banking and consumer finance entities outside their domestic markets and all other banking operations.*
- (v) *In 2004 non-equity minority interests were included within shareholders' equity and other non interest-bearing liabilities and the related coupon payments were included within [Profit attributable to minority interests].*

Share capital and reserves

The following events in relation to the share capital of HSBC Holdings occurred during the year:

Ordinary shares of US\$0.50 each

Scrip dividends

1. 24,184,953 ordinary shares were issued at par on 19 January 2006 to shareholders who elected to receive new shares in lieu of the third interim dividend for 2005. The market value per share used to calculate shareholders' entitlements to new shares was US\$16.2150, being the US dollar equivalent of £9.40.
2. 91,685,145 ordinary shares were issued at par on 11 May 2006 to shareholders who elected to receive new shares in lieu of the fourth interim dividend for 2005. The market value per share used to calculate shareholders' entitlements to new shares was US\$16.8175, being the US dollar equivalent of £9.621.
3. 14,090,830 ordinary shares were issued at par on 6 July 2006 to shareholders who elected to receive new shares in lieu of the first interim dividend for 2006. The market value per share used to calculate shareholders' entitlements to new shares was US\$17.5938, being the US dollar equivalent of £9.346.
4. 28,617,819 ordinary shares were issued at par on 4 October 2006 to shareholders who elected to receive new shares in lieu of the second interim dividend for 2006. The market value per share used to calculate shareholders' entitlements to new shares was US\$17.9844, being the US dollar equivalent of £9.51.

All-Employee share plans

5. 25,334,998 ordinary shares were issued at prices ranging from £5.3496 to £7.6736 and 926 ordinary shares were issued at HK\$103.4401 per share in connection with the exercise of options under the HSBC Holdings savings-related share option plans. Options over 7,870,495 ordinary shares lapsed.
6. 2,533,496 ordinary shares were issued at £11.3921 per share and 502,454 ordinary shares were issued at £12.8161 per share in connection with a Plan d'Epargne Entreprise for the benefit of non-UK resident employees of HSBC France and its subsidiaries.
7. Options over 22,626,714 ordinary shares were granted at nil consideration on 26 April 2006 to over 52,900 HSBC employees resident in nearly 60 countries and territories under the HSBC Holdings savings-related share option plans.

Discretionary share incentive plans

8. 9,767,102 ordinary shares were issued at prices ranging from £3.3334 to £7.7984 per share in connection with the exercise of options under the HSBC Holdings Executive Share Option Scheme. Options over 450,801 ordinary shares lapsed.
9. 37,817,808 ordinary shares were issued at prices ranging from £6.91 to £9.642 per share in connection with the exercise of options under the HSBC Holdings Group Share Option Plan. Options over 5,536,526 ordinary shares lapsed.

HSBC Finance

10. 3,424,742 ordinary shares were issued at US\$9.60 per share in connection with the early settlement and maturity of HSBC Finance 8.875 per cent Adjustable Conversion-Rate Equity Security Units.
11. 643,520 ordinary shares were issued at prices ranging from US\$16.06 to US\$18.79 per share in connection with the vesting of Restricted Stock Rights under HSBC Finance share plans that have been converted into rights over HSBC Holdings ordinary shares.

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Financial Review

(continued)

Other financial information > Share capital and reserves / Short term borrowings / Contractual obligations / Loan maturity

Authority to repurchase ordinary shares

12. At the Annual General Meeting in 2006, shareholders renewed the authority for the Company to make market repurchases of up to 1,137,200,000 ordinary shares. The Directors have not exercised this authority. In accordance with the terms of a waiver granted by the Hong Kong Stock Exchange on 19 December 2005, HSBC Holdings will comply with the applicable law and regulation in the UK in relation to the holding of any shares in treasury and with the conditions of the waiver, in connection with any shares it may hold in treasury.

Authority to allot shares

13. At the Annual General Meeting in 2006 shareholders renewed the authority for the Directors to allot new shares. The authority was to allot up to 2,274,400,000 ordinary shares, 10,000,000 non-cumulative preference shares of £0.01 each, 8,550,000 non-cumulative preference shares of US\$0.01 each and 10,000,000 non-cumulative preference shares of ¤0.01 each.

Other than as described in paragraphs 1 to 6 and 8 to 11 above, the Directors did not allot any shares during 2006.

Short-term borrowings

HSBC includes short-term borrowings within customer accounts, deposits by banks and debt securities in issue and does not show short-term borrowings separately on the balance sheet. Short-term borrowings are defined by the US Securities and Exchange Commission (SEC) as Federal funds purchased and securities sold under agreements to repurchase, commercial paper and other short-term borrowings. HSBC's only significant short-term borrowings are securities sold under agreements to repurchase and certain debt securities in issue. Additional information on these is provided in the tables below.

	Year ended 31 December		
	2006 US\$m	2005 US\$m	2004 US\$m
Securities sold under agreements to repurchase			
Outstanding at 31 December	97,139	75,745	43,726
Average amount outstanding during the year	102,715	74,143	46,229
Maximum quarter-end balance outstanding during the year	109,689	78,590	53,188
Weighted average interest rate during the year	4.3%	3.6%	2.7%
Weighted average interest rate at the year-end	4.6%	4.0%	2.9%
Short term bonds			
Outstanding at 31 December	37,906	40,642	36,085
Average amount outstanding during the year	37,729	31,908	29,238
Maximum quarter-end balance outstanding during the year	38,907	40,642	36,085
Weighted average interest rate during the year	5.1%	4.6%	2.8%

Weighted average interest **4.8%** 3.7% 2.5%
Contractual obligations

The table below provides details of HSBC's material contractual obligations as at 31 December 2006.

	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	295,334	94,334	120,642	80,358
Term deposits and certificates of deposit	209,339	188,520	20,819	□
Capital (finance) lease obligations	707	41	21	645
Operating lease obligations	4,308	799	2,311	1,198
Purchase obligations	1,259	611	648	□
Short positions in debt securities and equity shares	71,287	55,289	5,948	10,050
Pension obligations	9,613	1,153	2,272	6,188
	591,847	340,747	152,661	98,439

[Back to Contents](#)**Loan maturity and interest sensitivity analysis**

At 31 December 2006, the geographical analysis of loan maturity and interest sensitivity by loan type on a contractual repayment basis was as follows:

	Europe US\$m	Hong Kong US\$m	Rest of Asia- Pacific US\$m	North America US\$m	Latin America US\$m	Total US\$m
Maturity of 1 year or less						
Loans and advances to banks	74,381	50,306	26,913	17,673	9,974	179,247
Commercial loans to customers						
Commercial, industrial and international trade	67,619	12,560	20,839	4,098	6,378	111,494
Real estate and other property related	17,021	6,442	4,210	7,309	1,128	36,110
Non-bank financial institutions	35,616	1,221	2,071	11,105	1,095	51,108
Governments	1,256	265	1,114	115	486	3,236
Other commercial	37,976	2,059	5,220	8,025	2,371	55,651
	159,488	22,547	33,454	30,652	11,458	257,599
Hong Kong Government Home Ownership Scheme	□	451	□	□	□	451
Residential mortgages and other personal loans	37,027	10,791	11,107	49,495	7,298	115,718
Loans and advances to customers	196,515	33,789	44,561	80,147	18,756	373,768
	270,896	84,095	71,474	97,820	28,730	553,015
Maturity after 1 year but within 5 years						
Loans and advances to banks	2,066	53	250	166	135	2,670
Commercial loans to customers						
Commercial, industrial and international trade	19,472	3,992	3,867	5,662	2,916	35,909
Real estate and other property related	11,402	9,034	3,875	7,867	798	32,976
Non-bank financial institutions	3,384	348	797	932	486	5,947
Governments	408	286	491	81	2,548	3,814
Other commercial	9,609	2,629	2,542	2,070	1,238	18,088
	44,275	16,289	11,572	16,612	7,986	96,734
Hong Kong Government Home Ownership Scheme	□	1,410	□	□	□	1,410
Residential mortgages and other personal loans	42,271	7,088	8,255	54,970	4,088	116,672
Loans and advances to customers	86,546	24,787	19,827	71,582	12,074	214,816
	88,612	24,840	20,077	71,748	12,209	217,486
Interest rate sensitivity of loans and advances to banks and commercial loans to customers:						

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Fixed interest rate	10,142	79	2,195	3,299	4,036	19,751
Variable interest rate	36,199	16,263	9,627	13,479	4,085	79,653
	46,341	16,342	11,822	16,778	8,121	99,404
Maturity after 5 years						
Loans and advances to banks	390	□	354	26	2,525	3,295
Commercial loans to customers						
Commercial, industrial and international trade	11,936	293	490	1,244	743	14,706
Real estate and other property related	9,848	3,928	908	3,537	224	18,445
Non-bank financial institutions	1,055	763	58	221	52	2,149
Governments	696	□	311	24	909	1,940
Other commercial	10,129	1,688	929	733	513	13,992
	33,664	6,672	2,696	5,759	2,441	51,232
Hong Kong Government Home Ownership Scheme	□	2,217	□	□	□	2,217
Residential mortgages and other personal loans .	79,450	17,182	11,391	127,746	3,909	239,678
Loans and advances to customers	113,114	26,071	14,087	133,505	6,350	293,127
	113,504	26,071	14,441	133,531	8,875	296,422
Interest rate sensitivity of loans and advances to banks and commercial loans to customers						
Fixed interest rate	8,925	30	1,078	1,301	857	12,191
Variable interest rate	25,129	6,641	1,972	4,484	4,109	42,335
	34,054	6,671	3,050	5,785	4,966	54,526

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Financial Review

(continued)

*Other financial information > Deposits***Deposits**

The following tables analyse the average amount of bank deposits, customer deposits and certificates of deposit (CDs) and other money market instruments (which are included within debt securities in issue in the balance sheet), together with the average interest rates paid thereon for each of the past three years. The geographical analysis of average deposits is based on the location of the office in which the deposits are recorded and excludes balances with HSBC companies. The Other category includes securities sold under agreements to repurchase.

	Year ended 31 December					
	2006		2005		2004	
	Average balance US\$m	Average rate %	Average balance US\$m	Average rate %	Average balance US\$m	Average rate %
Deposits by banks						
Europe						
Demand and other non-interest bearing	9,814		14,252		14,746	
Demand interest bearing	8,368	3.7	9,418	2.9	9,237	1.5
Time	27,447	4.0	28,021	3.0	22,029	2.8
Other	23,396	3.5	16,111	3.6	22,870	2.5
	69,025		67,802		68,882	
Hong Kong						
Demand and other non-interest bearing	1,031		2,054		1,752	
Demand interest bearing	2,428	4.6	3,104	3.5	2,484	1.2
Time	2,016	4.3	2,012	3.2	1,016	1.6
Other	362	3.3	218	2.3	416	1.7
	5,837		7,388		5,668	
Rest of Asia-Pacific						
Demand and other non-interest bearing	1,618		2,164		1,641	
Demand interest bearing	1,960	2.4	1,442	1.9	1,013	2.3
Time	3,645	4.8	4,375	4.3	4,410	3.1
Other	2,157	4.5	761	5.4	1,146	2.7
	9,380		8,742		8,210	
North America						
Demand and other non-interest bearing	767		1,334		1,670	
Demand interest bearing	3,033	5.3	3,647	3.6	3,025	1.4
Time	3,543	5.4	2,406	6.0	1,861	3.0
Other	699	5.6	38	5.3	4,436	1.8

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	8,042		7,425		10,992	
Latin America						
Demand and other <input type="checkbox"/> non-interest bearing	702	<input type="checkbox"/>	49	<input type="checkbox"/>	291	<input type="checkbox"/>
Demand <input type="checkbox"/> interest bearing	96	6.3	117	7.7	221	5.4
Time	1,732	5.5	1,810	6.4	1,553	4.1
Other	683	9.4	1,075	8.9	747	5.6
	3,213		3,051		2,812	
Total						
Demand and other <input type="checkbox"/> non-interest bearing	13,932	<input type="checkbox"/>	19,853	<input type="checkbox"/>	20,100	<input type="checkbox"/>
Demand <input type="checkbox"/> interest bearing	15,885	4.5	17,728	3.1	15,980	1.5
Time	38,383	4.5	38,624	3.5	30,869	2.9
Other	27,297	3.9	18,203	4.1	29,615	2.4
	95,497		94,408		96,564	

[Back to Contents](#)

Year ended 31 December

	2006		2005		2004	
	Average balance US\$m	Average rate %	Average balance US\$m	Average rate %	Average balance US\$m	Average rate %
Customer accounts						
Europe						
Demand and other □ non-interest bearing	33,000	□	28,501	□	37,184	□
Demand □ interest bearing	173,150	2.7	146,484	2.4	128,249	2.0
Savings	50,525	3.9	46,248	3.3	37,846	2.5
Time	59,374	4.2	48,201	3.9	47,941	3.1
Other	9,249	4.1	10,967	2.7	15,167	2.2
	325,298		280,401		266,387	
Hong Kong						
Demand and other □ non-interest bearing	12,362	□	13,365	□	13,508	□
Demand □ interest bearing	88,754	2.4	91,723	0.9	94,629	0.1
Savings	58,883	3.8	50,281	2.4	46,817	1.0
Time	20,454	3.6	14,054	2.7	12,015	1.6
Other	51	3.9	15	6.7	106	4.7
	181,153		169,438		167,075	
Rest of Asia-Pacific						
Demand and other □ non-interest bearing	13,107	□	11,825	□	8,592	□
Demand □ interest bearing	29,816	2.1	27,721	1.7	24,480	1.2
Savings	42,153	4.3	31,584	3.3	27,171	2.9
Time	10,246	4.5	10,484	3.5	7,597	2.1
Other	2,233	3.5	1,895	3.9	2,866	1.2
	97,555		83,509		70,706	
North America						
Demand and other □ non-interest bearing	13,662	□	13,627	□	18,735	
Demand □ interest bearing	14,406	2.9	11,723	1.9	10,730	1.1
Savings	65,216	2.8	52,458	1.6	51,780	1.3
Time	21,124	5.4	21,759	3.6	12,267	2.1
Other	3,339	2.0	2,549	4.5	13,119	1.6
	117,747		102,116		106,631	
Latin America						
Demand and other □ non-interest bearing	7,995	□	5,583	□	4,201	□
Demand □ interest bearing	5,438	1.6	6,341	1.2	5,973	1.1
Savings	16,512	11.3	10,980	15.2	7,115	11.5
Time	7,665	5.9	2,529	5.6	1,973	3.6
Other	2,145	13.4	1,429	17.5	4,281	7.4
	39,757		26,862		23,543	
Total						
Demand and other □ non-interest bearing	80,126	□	72,901	□	82,220	□
Demand □ interest bearing	311,564	2.6	283,992	1.8	264,061	1.2

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Savings	233,289	4.1	191,551	3.3	170,729	2.2
Time	118,863	4.5	97,027	3.7	81,793	2.6
Other	17,666	4.6	16,855	4.4	35,539	2.5
	761,510		662,326		634,342	

CDs and other money market instruments

Europe	48,238	4.2	27,778	5.8	24,684	2.6
Hong Kong	1,191	3.5	1,599	3.1	10,031	3.3
Rest of Asia-Pacific	6,621	5.6	7,467	6.2	6,804	4.4
North America	23,472	4.6	19,566	3.1	17,224	1.8
Latin America	318	10.7	4,657	6.4	3,668	4.1
	79,840	4.5	61,067	5.0	62,411	2.9

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Financial Review

(continued)

Other financial information > Certificates of deposit and other time deposits / Off-balance sheet arrangements

Certificates of deposit and other time deposits

At 31 December 2006, the maturity analysis of certificates of deposit and other wholesale time deposits, by remaining maturity, was as follows:

	3 months or less US\$m	After 3 months but within 6 months US\$m	After 6 months but within 12 months US\$m	After 12 months US\$m	Total US\$m
Europe					
Certificates of deposit	16,471	1,721	170	□	18,362
Time deposits:					
□ banks	26,492	3,089	1,611	3,227	34,419
□ customers	58,703	3,684	1,625	3,776	67,788
	<u>101,666</u>	<u>8,494</u>	<u>3,406</u>	<u>7,003</u>	<u>120,569</u>
Hong Kong					
Certificates of deposit	608	738	1,999	6,701	10,046
Time deposits:					
□ banks	1,312	88	64	34	1,498
□ customers	15,337	300	293	1,227	17,157
	<u>17,257</u>	<u>1,126</u>	<u>2,356</u>	<u>7,962</u>	<u>28,701</u>
Rest of Asia-Pacific					
Certificates of deposit	3,916	986	855	299	6,056
Time deposits:					
□ banks	3,610	1,165	109	191	5,075
□ customers	9,677	490	223	1,800	12,190
	<u>17,203</u>	<u>2,641</u>	<u>1,187</u>	<u>2,290</u>	<u>23,321</u>
North America					
Certificates of deposit	□	□	□	□	□
Time deposits:					
□ banks	3,792	255	345	□	4,392
□ customers	12,152	1,317	1,709	1,669	16,847
	<u>15,944</u>	<u>1,572</u>	<u>2,054</u>	<u>1,669</u>	<u>21,239</u>

Latin America

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Certificates of deposit				389	389
Time deposits:					
□ banks	1,884	492	321	817	3,514
□ customers	9,282	546	1,089	689	11,606
	11,166	1,038	1,410	1,895	15,509
Total					
Certificates of deposit	20,995	3,445	3,024	7,389	34,853
Time deposits:					
□ banks	37,090	5,089	2,450	4,269	48,898
□ customers	105,151	6,337	4,939	9,161	125,588
	163,236	14,871	10,413	20,819	209,339

The geographical analysis of deposits is based on the location of the office in which the deposits are recorded and excludes balances with HSBC companies. The majority of certificates of deposit and time deposits are in amounts of US\$100,000 and over or the equivalent in other currencies.

[Back to Contents](#)**Off-balance sheet arrangements**

HSBC enters into certain off-balance sheet arrangements with customers in the ordinary course of business, as described below.

(i) Financial guarantees, letters of credit and similar undertakings

Note 41 on the Financial Statements on page 396 describes various types of guarantees and discloses the maximum potential future payments under such arrangements. Credit risk associated with all forms of guarantees is assessed in the same manner as for on-balance sheet credit advances and, where necessary, provisions for assessed impairment are included in [Other provisions].

(ii) Commitments to lend

Undrawn credit lines are disclosed in Note 41 on the Financial Statements on page 396. The majority by value of undrawn credit lines arise from [open to buy] lines on personal credit cards, cheques issued to potential customers offering them a pre-approved loan, advised overdraft limits, and mortgage offers awaiting customer acceptance. HSBC generally has the right to change or terminate any conditions of a personal customer's overdraft, credit card or other credit line upon notification to the customer. In respect of corporate commitments to lend, in most contracts HSBC's position will be protected through restrictions on access to funding in the event of material adverse change.

(iii) Credit derivatives

HSBC uses credit derivatives through its principal dealing operations, acting as a principal counterparty to a broad range of users, structuring deals to produce risk management products for its customers, or making markets in certain products. Risk is typically controlled through entering into offsetting credit derivative contracts with other counterparties.

HSBC manages the credit risk arising on buying and selling credit derivative protection by including the exposure to any credit risk that arises from such transactions within its overall credit limits structure to the relevant counterparty. The trading of credit derivatives is restricted to a small number of offices within the major centres which in management's view have the control infrastructure and market skills to manage effectively the credit risk inherent in the products.

Credit derivatives are also used for the management of credit risk in the Group's loan portfolio. HSBC's use of credit derivatives in this manner is not significant, however. The following table presents the notional amounts of credit derivatives protection bought and sold by HSBC:

	At 31 December	
	2006	2005
	US\$m	US\$m
Notional amount of protection bought	540,229	249,347
Notional amount of protection sold	569,599	262,393

The mismatch between these notional amounts is attributable to HSBC selling protection on large, diversified, predominantly investment grade portfolios (including the most senior tranches) and then hedging these positions by buying protection on the more subordinated tranches of the same portfolios. In addition, HSBC uses securities to hedge certain derivative positions. Consequently, while there is a mismatch in notional amounts of credit derivatives, the risk positions are largely matched.

(iv) Special purpose and variable interest entities

HSBC predominantly uses special purpose entities (SPEs) or variable interest entities (VIEs) to securitise loans and advances it has originated where this source of funding is cost effective. Such loans and advances generally remain on the balance sheet under IFRSs.

HSBC also administers SPEs that have been established for the purpose of providing alternative sources of financing to HSBC's customers. Such arrangements also enable HSBC to provide tailored investment opportunities for investors. These SPEs, commonly referred to as asset-backed or multi-seller conduits, purchase interests in a diversified pool of receivables from customers or in the market using finance provided by a third party. The cash flows received by SPEs on pools of receivables are used to service the finance provided by

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: Financial Review

(continued)

Other financial information > Off balance sheet arrangements / Regulation and supervision

investors. HSBC administers this arrangement, which facilitates diversification of funding sources and the tranching of credit risk. HSBC also typically provides part of the liquidity facilities to the entities, together with secondary credit enhancement.

HSBC also has relationships with SPEs which offer management of investment funds, provide finance to public and private sector infrastructure projects, and facilitate capital funding through the issue of preference shares via partnerships.

All SPEs used by HSBC are authorised centrally upon initial establishment to ensure appropriate purpose and governance. The activities of SPEs administered by HSBC are closely monitored by senior management. The use of SPEs is not a significant part of HSBC's activities and HSBC is not reliant on the use of SPEs for any material part of its business operations or profitability. For a further discussion of HSBC's involvement with SPEs and the accounting treatments under IFRSs and US GAAP, see Note 47(j) on the Financial Statements on page 429.

Disclosure controls

The Group Chairman and Group Finance Director, with the assistance of other members of management, carried out an evaluation of the effectiveness of the design and operation of HSBC Holdings' disclosure controls and procedures as of 31 December 2006. Based upon that evaluation, the Group Chairman and Group Finance Director concluded that HSBC's disclosure controls and procedures as of 31 December 2006 were effective to provide reasonable assurance that information required to be disclosed in the reports which the company files and submits under the US Securities Exchange Act of 1934, as amended, is recorded, processed, summarised and reported as and when required. There are inherent limitations to the effectiveness of any system of disclosure controls and procedures, including the possibility of human error and the circumvention or overriding of the controls and procedures. Accordingly, even effective disclosure controls and procedures can only provide reasonable assurance of achieving their control objectives.

There has been no change in HSBC Holdings' internal control over financial reporting during the year ended 31 December 2006 that has materially affected, or is reasonably likely to materially affect, HSBC Holdings' internal control over financial reporting.

Management's assessment of internal controls

Management is responsible for establishing and maintaining an adequate internal control structure and procedures for financial reporting, and has completed an assessment of the effectiveness of the Group's internal control over financial reporting as of 31 December 2006. In making the assessment, management used the framework for Director's internal control evaluation contained within the Combined Code (the Revised Turnbull Guidance), as well as the criteria established by the Committee of Sponsoring Organisations of the Treadway Commission (COSO) in the Internal Control-Integrated Framework.

Based on the assessment performed, management concluded that as at 31 December 2006, the Group's internal control over financial reporting was effective.

KPMG Audit Plc, which has audited the consolidated financial statements of the Group for the year ended 31 December 2006, has also audited management's assessment of the effectiveness of internal control over financial reporting and the effectiveness of the Group's internal control over financial reporting under Auditing Standard No. 2 of the Public Company Accounting Oversight Board (United States).

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: The Management of Risk

Regulation and supervision

	<i>Page</i>
<u>Regulation and supervision</u> ¹	<u>165</u>
<u>Risk management</u> ¹	<u>170</u>
<u>Credit risk</u>	<u>171</u>
<u>Credit risk management</u> ²	<u>171</u>
<u>Credit exposure</u> ³	<u>176</u>
<u>Credit quality</u> ³	<u>192</u>
<u>Impairment allowances and charges</u> ³	<u>197</u>
<u>HSBC Holdings</u> ²	<u>211</u>
<u>Risk elements in the loan portfolio</u> ¹	<u>211</u>
<u>Liquidity and funding management</u>	<u>213</u>
<u>Policies and procedures</u> ²	<u>213</u>
<u>Primary sources of funding</u> ³	<u>213</u>
<u>HSBC Holdings</u> ²	<u>215</u>
<u>Market risk management</u>	<u>216</u>
<u>Value at risk</u> ³	<u>216</u>
<u>Trading portfolios</u> ²	<u>218</u>
<u>Non-trading portfolios</u> ²	<u>219</u>
<u>Sensitivity of net interest income</u> ¹	<u>221</u>
<u>Structural foreign exchange exposures</u> ¹	<u>223</u>
<u>HSBC Holdings</u> ³	<u>223</u>
<u>Residual value risk management</u> ¹	<u>224</u>
<u>Operational risk management</u> ¹	<u>225</u>
<u>Legal litigation risk</u> ¹	<u>225</u>
<u>Pension risk</u> ¹	<u>226</u>
<u>Reputational risk management</u> ¹	<u>227</u>
<u>Sustainability risk management</u> ¹	<u>227</u>
<u>Risk management of insurance operations</u> ²	<u>228</u>
<u>Life insurance business</u> ²	<u>228</u>
<u>Non-life insurance business</u> ²	<u>228</u>
<u>Insurance risk</u> ²	<u>229</u>
<u>Financial risks</u> ²	<u>233</u>
<u>Market risk</u> ²	<u>235</u>
<u>Credit risk</u> ²	<u>237</u>
<u>Liquidity risk</u> ²	<u>240</u>
<u>Present value of in-force long-term insurance business</u> ²	<u>241</u>
<u>Capital management and allocation</u>	<u>243</u>
<u>Capital management</u> ²	<u>243</u>
<u>Capital measurement and allocation</u> ³	<u>243</u>
<u>Risk-weighted assets by principal subsidiary</u> ¹	<u>247</u>

1 Unaudited.

2 Audited.

3 Audited where indicated.

Regulation and supervision

(Unaudited)

With listings of its ordinary shares in London, Hong Kong, New York, Paris and Bermuda, HSBC Holdings complies with the relevant requirements for listing and trading on each of these exchanges. In the UK, these are the Listing Rules of the Financial Services Authority (FSA); in Hong Kong, The Rules Governing the Listing of

Securities on The Stock Exchange of Hong Kong Limited; 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. 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 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 applicable to companies with secondary listings.

A statement of HSBC's compliance with the code provisions of the Combined Code on Corporate Governance issued by the Financial Reporting Council and with the Code on Corporate Governance Practices in Appendix 14 to the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited is set out in the 'Report of the Directors: Governance' on page 248.

HSBC's operations throughout the world are regulated and supervised by approximately 510 different central banks and regulatory authorities in those jurisdictions in which HSBC has offices, branches or subsidiaries. These authorities impose a variety of requirements and controls designed to improve financial stability and the transparency of financial markets and their contribution to economic growth. These regulations and controls cover, *inter alia*, capital adequacy, depositor protection, market liquidity, governance standards, customer protection (for example, fair lending practices, product design, and marketing and documentation standards), and social responsibility obligations (for example, anti-money laundering and anti-terrorist financing measures). In addition, a number of countries in which HSBC operates impose rules that affect, or place limitations on, foreign or foreign-owned or controlled banks and financial institutions. The rules include restrictions on the opening of local offices, branches or subsidiaries and the types of banking and non-banking activities that may be conducted by those local offices, branches or subsidiaries; restrictions on the acquisition of local banks or

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: The Management of Risk (continued)*Regulation and supervision*

regulations requiring a specified percentage of local ownership; and restrictions on investment and other financial flows entering or leaving the country. The supervisory and regulatory regimes of the countries where HSBC operates will determine to some degree HSBC's ability to expand into new markets, the services and products that HSBC will be able to offer in those markets and how HSBC structures specific operations.

The FSA supervises HSBC on a consolidated basis. In addition, each operating bank, finance company or insurance operation within HSBC is regulated by local supervisors. The primary regulatory authorities are those in the UK, Hong Kong and the US, the Group's principal areas of operation.

In June 2004, the Basel Committee on Banking Supervision introduced a new capital adequacy framework to replace the 1988 Basel Capital Accord in the form of a final Accord (commonly known as "Basel II"). Details of the EU's implementation of Basel II and how this will affect HSBC are set out on page 244.

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"). Other UK primary and secondary banking legislation is derived from EU directives relating to banking, securities, insurance investment and sales of personal financial services.

The FSA is responsible for authorising and supervising UK financial services institutions and regulates all HSBC's businesses in the UK which require authorisation under the FSMA. These include retail banking, life and general insurance, pensions, mortgages, custody and branch share-dealing businesses, and treasury and capital markets activity. HSBC Bank is HSBC's principal authorised institution in the UK.

FSA rules establish the minimum criteria for authorisation for banks and financial services businesses in the UK. They also set out reporting (and, as applicable, consent) requirements with regard to large individual exposures and large exposures to related borrowers. In its capacity as supervisor of HSBC on a consolidated basis, the FSA receives information on the capital adequacy of, and sets requirements for, HSBC as a whole. Further details on capital measurement are included in "Capital Management" on pages 243 to 247. The FSA's approach to capital requirements for UK insurers is to require minimum capital to be

calculated on two bases. First, firms must calculate their liabilities on a prudent basis and add a statutory solvency margin (Pillar 1). Secondly, firms must calculate their liabilities on a realistic basis then add to this their own calculation of risk-based capital. The sum of realistic reserves and risk-based capital (Pillar 2) is agreed with the FSA. Insurers are required to maintain capital equal to the higher of Pillars 1 and 2. The FSA has the right to object, on prudential grounds, to persons who hold, or intend to hold, 10 per cent or more of the voting power of a financial institution.

The regulatory framework of the UK financial services system has traditionally been based on co-operation between the FSA and authorised institutions. The FSA monitors authorised institutions through ongoing supervision and the review of routine and *ad hoc* reports relating to financial and prudential matters. The FSA may periodically obtain independent reports, usually from the auditors of the authorised institution, as to the adequacy of internal control procedures and systems as well as procedures and systems governing records and accounting. The FSA meets regularly with HSBC's senior executives to discuss HSBC's adherence to the FSA's prudential guidelines. They also regularly discuss fundamental matters relating to HSBC's business in the UK and internationally, including areas such as strategic and operating plans, risk control, loan portfolio composition and organisational changes, including succession planning.

UK depositors and investors are covered by the Financial Services Compensation Scheme, which deals with deposits with authorised institutions in the UK, investment business and contracts of insurance. Institutions authorised to accept deposits and conduct investment business are required to contribute to the funding of the scheme. In the event of the insolvency of an authorised institution, depositors are entitled to receive 100 per cent of the first £2,000 (US\$3,927) of a claim plus 90 per cent of any further amount up to £33,000 (US\$64,794) (the maximum amount payable being £31,700 (US\$62,241)). Payments under the scheme in respect of investment business compensation are limited to 100 per cent of the first £30,000 (US\$58,903) of a claim plus 90 per cent of any further amount up to £20,000 (US\$39,269) (the maximum amount payable being £48,000 (US\$94,246)). In addition, the Financial Services Compensation Scheme has been extended to cover mortgage advice and arranging, certain long term and general insurance products, and the provision of general advice and

[Back to Contents](#)

arranging services. Differing levels of compensation limits apply to each of these additional areas.

The EU Savings Directive took effect on 1 July 2005. Under the directive, each member state other than Austria, Belgium, and Luxembourg is required to provide the tax authorities of each other member state with details of payments of interest or other similar income paid by a person within its jurisdiction to individuals resident in such other member state. For a transitional period beginning on the same date, Austria, Belgium, and Luxembourg have imposed a withholding tax on such income. The withholding tax rate is 15 per cent, increasing to 20 per cent from 2008 and 35 per cent from 2011. Subject to future conditions being met, Austria, Belgium, and Luxembourg may cease to apply the withholding tax and instead comply with the automatic exchange of information rules applicable to the other member states. These future conditions will depend on other key financial centres – Switzerland, Liechtenstein, San Marino, Andorra and the US – not exchanging information. These financial centres and several other European countries and related offshore territories have also entered into similar agreements to the Savings Directive with the EU states.

Hong Kong regulation and supervision

Banking in Hong Kong is subject to the provisions of the Banking Ordinance (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, which may deny the acquisition of voting power of over 10 per cent in a bank, and may attach conditions to its approval thereof, can effectively control changes in the ownership and control of Hong Kong-incorporated financial institutions. In addition, the HKMA has the power to divest controlling interests in a bank from persons if they are no longer deemed to be fit and proper, if they may otherwise threaten the interests of depositors or potential depositors, or if they have contravened any conditions specified by the HKMA. The HKMA may revoke authorisation in the event of an institution’s non-compliance with the provisions of the Banking Ordinance. These provisions require, among other things, the furnishing of accurate reports.

The Banking Ordinance requires that banks submit to the HKMA certain returns and other information and establishes certain minimum standards and ratios relating to capital adequacy (see below), liquidity, capitalisation, limitations on shareholdings, exposure to any one customer, unsecured advances to persons affiliated with the bank and holdings of interests in land, with which banks must comply.

Hong Kong fully implemented the capital adequacy standards established by the 1988 Basel Capital Accord. The Banking Ordinance currently provides that banks incorporated in Hong Kong maintain a capital adequacy ratio (calculated as the ratio, expressed as a percentage, of the bank’s capital base to its risk-weighted exposure) of at least 8 per cent. For banks with subsidiaries, the HKMA is empowered to require that the ratio be calculated on a consolidated basis, or on both consolidated and unconsolidated bases. If circumstances require, the HKMA is empowered to increase the minimum capital adequacy ratio (to up to 16 per cent), after consultation with the bank.

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A deposit protection scheme came into force during 2006 pursuant to the Deposit Protection Scheme Ordinance. The Scheme only covers standard deposits held with licensed banks in Hong Kong subject to a maximum of HK\$100,000 (US\$12,860).

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

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: The Management of Risk (continued)**Regulation and supervision**

Kong (the "Securities and Futures Ordinance"). Entities engaging in activities regulated by the Securities and Futures Ordinance are required to be licensed. The HKMA is the primary regulator for banks involved in the securities business, while the Securities and Futures Commission is the regulator for non-banking entities.

In Hong Kong, insurance business is regulated under the Insurance Companies Ordinance and by the Insurance Authority of Hong Kong ("IA"). The IA is responsible for the licensing of insurers and insurance brokers, although insurance business can also be licensed by the Confederation of Insurance Brokers (the "CIB"). Separately, insurance agents are licensed by the Hong Kong Federation of Insurers (the "HKFI"). Both the HKFI and the CIB have enacted Codes of Conduct for insurance agents and brokers respectively and can impose sanctions for misbehaviour or breach.

HSBC Insurance (Asia-Pacific) Holdings Limited ("INAH") is licensed by the IA as an insurer. The Hongkong and Shanghai Banking Corporation, which is authorised by the HKFI, acts as an agent for INAH, and HSBC Insurance Brokers (Asia-Pacific) Limited act as insurance brokers licensed by the CIB.

US regulation and supervision

HSBC is subject to extensive federal and state supervision and regulation in the US. Banking laws and regulations of the Federal Reserve Board, the Office of the Comptroller of the Currency ("OCC") and the Federal Deposit Insurance Corporation ("FDIC") govern many aspects of HSBC's US business.

HSBC and its US operations are subject to supervision, regulation and examination by the Federal Reserve Board because HSBC is a "bank holding company" under the US Bank Holding Company Act of 1956 (the "BHCA"). HSBC and HSBC North America Holdings Inc. ("HNAH"), formed to hold all of its North American operations, are "bank holding companies" by virtue of their ownership and control of HSBC Bank USA, N.A. ("HSBC Bank USA"), HSBC National Bank USA ("HSBC Bank Maryland"), and HSBC Trust Company (Delaware), N.A. ("HSBC Bank Delaware"). These three banks are nationally chartered commercial banks and members of the Federal Reserve System. HSBC Bank Maryland is a new bank that opened for business on 30 October 2006. HSBC Bank Delaware opened on 1 July 2005, as an institution limited to trust activities. On 24 November 2006, having received federal deposit

insurance, it expanded to become a full-service commercial bank. HSBC also owns HSBC Bank Nevada, N.A. ("HSBC Bank Nevada"), a nationally chartered bank limited to credit card activities which is also a member of the Federal Reserve System. These four banks are subject to regulation, supervision and examination by the OCC and, as their deposits are insured by the FDIC, they are subject to relevant FDIC regulation. Both HSBC and HNAH are registered as financial holding companies ("FHCs") under the BHCA, enabling them to offer a broad range of financial products and services through their subsidiaries. HSBC's and HNAH's ability to engage in expanded financial activities as FHCs depend upon HSBC and HNAH continuing to meet certain criteria set forth in the BHCA, including requirements that their US depository institution subsidiaries, HSBC Bank USA, HSBC Bank Maryland, HSBC Bank Nevada and HSBC Bank Delaware, be "well capitalised" and "well managed", and that such institutions have achieved at least a satisfactory record in meeting community credit needs during their most recent examinations pursuant to the Community Reinvestment Act. These requirements also apply to Wells Fargo HSBC Trade Bank, N.A., in which HSBC and HNAH have a 20 per cent voting interest in equity capital and a 40 per cent economic interest. Each of these depository institutions achieved at least the required rating during their most recent examinations. At 31 December 2006, HSBC Bank USA, HSBC Bank Maryland, HSBC Bank Nevada, HSBC Bank Delaware and Wells Fargo HSBC Trade Bank, N.A. were each well capitalised and well managed under Federal Reserve Board regulations.

In general under the BHCA, an FHC would be required, upon notice by the Federal Reserve Board, to enter into an agreement with the Federal Reserve Board to correct any failure to comply with the requirements to maintain FHC status. Until such deficiencies are corrected, the Federal Reserve Board may impose limitations on the US activities of an FHC and depository institutions under its control. If such deficiencies are not corrected, the Federal Reserve Board may require an FHC to divest its control of any subsidiary depository institution or to desist from certain financial activities in the US.

HSBC and HNAH are generally prohibited under the BHCA from acquiring, directly or indirectly, ownership or control of more than 5 per cent of any class of voting shares of, or substantially all the assets of, or exercising control over, any US bank, bank holding company or many other types of depository institutions and/or their holding companies without the prior approval of the Federal

[Back to Contents](#)

Reserve Board and potentially other US banking regulatory agencies.

The Gramm-Leach-Bliley Act of 1999 ("GLBA") and the regulations issued thereunder contain a number of other provisions that could affect HSBC's operations and the operations of all financial institutions. One such provision relates to the financial privacy of consumers. In addition, the so-called "push-out" provisions of GLBA narrow the exclusion of banks (including HSBC Bank USA, N.A. from the definitions of "broker" and "dealer" under the Exchange Act of 1934, as amended ("Exchange Act"). The SEC has granted a series of temporary exemptions to delay the required implementation of these push-out provisions. The narrowed "dealer" definition took effect in September 2003, and the narrowed "broker" definition is currently expected to take effect no earlier than July 2007. As a result, it is likely that certain securities activities currently conducted by HSBC Bank USA will need to be restructured or transferred to one or more US-registered broker-dealer affiliates.

The US is party to the 1988 Basel Capital Accord, and US banking regulatory authorities have adopted risk-based capital requirements for US banks and bank holding companies that are generally consistent with the Accord. In addition, US regulatory authorities have adopted "leverage" capital requirements that generally require US banks and bank holding companies to maintain a minimum amount of capital in relation to their balance sheet assets (measured on a non-risk-weighted basis).

The Federal Deposit Insurance Corporation Improvement Act of 1991 provides for extensive regulation of insured depository institutions (such as HSBC Bank USA, HSBC Bank Maryland, HSBC Bank Delaware, HSBC Bank Nevada and Wells Fargo HSBC Trade Bank, N.A.), including requiring federal banking regulators to take "prompt corrective action" with respect to FDIC-insured banks that do not meet minimum capital requirements.

HSBC Bank USA, HSBC Bank Maryland, HSBC Bank Delaware, HSBC Bank Nevada and Wells Fargo HSBC Trade Bank, N.A., like other FDIC-insured banks, may be required to pay assessments to the FDIC for deposit insurance under the FDIC's Bank Insurance Fund. Under the FDIC's risk-based system for setting deposit insurance assessments, an institution's assessments vary according to the level of capital an institution holds, its deposit levels and other factors.

The USA Patriot Act ("Patriot Act") imposes significant record keeping and customer identity requirements, expands the US federal government's

powers to freeze or confiscate assets and increases the available penalties that may be assessed against financial institutions for failure to comply with obligations imposed on such institutions to detect, prevent and report money laundering and terrorist financing. Pursuant to the Patriot Act, final regulations are in effect which impose anti-money laundering compliance obligations on financial institutions (a term which, for this purpose, includes insured US depository institutions, US branches and agencies of foreign banks, US broker-dealers and numerous other entities). Many of the anti-money laundering compliance requirements imposed by the Patriot Act and these implementing regulations are generally consistent with the anti-money laundering compliance obligations existing for banks prior to the Patriot Act. These include requirements to adopt and implement an anti-money laundering programme, report suspicious transactions and implement due diligence procedures for certain correspondent and private banking accounts. Certain other specific requirements of the Patriot Act were new compliance obligations. The passage of the Patriot Act and other recent events have resulted in heightened scrutiny of the Bank Secrecy Act and anti-money laundering compliance by federal and state bank examiners.

If HSBC were to fail to maintain and implement adequate programmes to combat money laundering and terrorist financing and to comply with economic sanctions, or was found to be in breach of relevant laws and regulations, including by failing to observe economic sanctions, serious legal and reputational consequences for the Group could arise.

HSBC 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, HSBC monitors activities relating to Cuba, Iran, Myanmar, North Korea, Sudan and Syria. HSBC's business activities include correspondent banking services to banks located in some of these countries and private banking services for nationals of, and clients domiciled in, some of the above countries. The Group has a small representative office in Tehran, Iran.

The US State Department has designated such countries 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

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: The Management of Risk (continued)*Regulation and supervision / Risk management / Credit risk*

transactions with or investments in entities doing business with such countries. HSBC does not believe its business activities with counterparties in, or directly relating to, such countries are material to its business, and such activities represented a very small part of total assets as of 31 December 2006 and total revenues for the year ended 31 December 2006.

HSBC's US insurance agency and underwriting operations are subject to regulatory supervision under the laws of the states in which they operate. Insurance laws and regulations vary from state to state but generally require forms and rates to be filed with, and approved by, the state insurance departments, and cover licensing of insurance companies; corporate governance; premiums and loss rates; dividend restrictions; types of insurance that may be sold; underwriting processes; permissible investments; reserve requirements; and insurance advertising and marketing practices. Each HSBC US insurance subsidiary undergoes periodic market conduct and financial examinations by the relevant state insurance departments, and HSBC's insurance agencies and agents are subject to state licensing and registration requirements. Additionally, with respect to credit insurance, because it is sold in connection with a loan, state loan laws often contain requirements related to offering, cancelling and refunding credit insurance. Although insurance is not generally regulated by the federal government, certain federal regulations related to lending disclosures apply to the sale and cancellation of credit insurance.

HSBC's US consumer finance operations are subject to extensive state-by-state regulation in the US, and to laws relating to consumer protection (both in general, and in respect of "sub-prime" lending operations, which have been subject to enhanced regulatory scrutiny); discrimination in extending credit; use of credit reports; privacy matters; disclosure of credit terms; and correction of billing errors. They also are subject to regulations and legislation that limit operations in certain jurisdictions. For example, limitations may be placed on the amount of interest or fees that a loan may bear, the amount that may be borrowed, the types of actions that may be taken to collect or foreclose upon delinquent loans or the information about a customer that may be shared. HSBC's US consumer finance branch lending offices are generally licensed in those jurisdictions in which they operate. Such licences have limited terms but are renewable, and are revocable for cause. Failure to comply with applicable laws and regulations may limit the ability of these licensed lenders to collect or enforce loan agreements made with consumers and may cause the

consumer finance lending subsidiary and/or its control person to be liable for damages and penalties.

HSBC's US credit insurance operations are subject to regulatory supervision under the laws of the states in which they operate. Regulations vary from state to state but generally cover licensing of insurance companies; premiums and loss rates; dividend restrictions; types of insurance that may be sold; permissible investments; policy reserve requirements; and insurance marketing practices.

Certain US source payments to foreign persons may be subject to US withholding tax unless the foreign person is a "qualified intermediary". A qualified intermediary is a financial intermediary which is qualified under the US Internal Revenue Code of 1986 and has completed the Qualified Intermediary Withholding Agreement with the Internal Revenue Service. Various HSBC operations outside the US are qualified intermediaries.

Risk management*(Unaudited)*

All HSBC's activities involve analysis, evaluation, acceptance and management of some degree of risk or combination of risks. The most important types of risk are credit risk (which includes country and cross-border

risk), liquidity risk, market risk, residual value risk, reputational risk, operational risk, pension risk, insurance risk and sustainability (environmental or social) risks. Market risk includes foreign exchange, interest rate and equity price risk.

HSBC's risk management policies are designed to identify and analyse these risks, to set appropriate risk limits and controls, and to monitor the risks and adherence to limits by means of reliable and up-to-date administrative and information systems. HSBC regularly reviews its risk management policies and systems to reflect changes in markets, products and emerging best practice. Individual responsibility and accountability, instilled through training, are designed to deliver a disciplined, conservative and constructive culture of risk management and control.

The Group Management Board formulates high level Group risk management policy under authority delegated by the Board of Directors. A separately convened Risk Management Meeting of the Group Management Board monitors risk and receives reports which allow it to review the effectiveness of HSBC's risk management policies.

The management of all risks that are significant to HSBC is discussed below. Given the distinct characteristics of the Group's insurance businesses

[Back to Contents](#)

the management of their credit, liquidity and market risk along with insurance risk, is discussed separately in [Risk management of insurance operations](#) section.

Credit risk

Credit risk management

(Audited)

Credit risk is the risk of financial loss if a customer or counterparty fails to meet an obligation under a contract. It arises principally from lending, trade finance, treasury and leasing business. Credit risk also arises when issuers of debt securities are downgraded and, as a result, the value of HSBC's holdings of assets falls. HSBC has standards, policies and procedures dedicated to controlling and monitoring risk from all such activities.

Within Group Head Office, a specialised function, Group Credit and Risk, is mandated to provide high-level centralised management of credit risk for HSBC worldwide. Group Credit and Risk is headed by a Group General Manager who reports to the Group Chief Executive. Its responsibilities include the following:

- Formulating Group credit policies and monitoring compliance with them. These policies are embodied in the HSBC standards with which all HSBC's operating companies are required to comply, and consistent with which they must formulate and record in instruction manuals their detailed credit policies and procedures.
- Issuing policy guidelines to HSBC's operating companies on the Group's attitude toward, and appetite for, credit risk exposure to specified market sectors, activities and banking products. Each HSBC operating company and major business unit is required to base its own lending guidelines on HSBC's standards, to regularly update them and disseminate them to its credit and lending executives. Group Credit and Risk controls HSBC's exposures to the automotive and hedge fund sectors, and closely monitors exposures to others such as real estate and securities houses. When necessary, restrictions are imposed on new business or exposures in HSBC's operating companies are capped.
- Undertaking an independent review and objective assessment of risk. Group Credit and Risk assesses all commercial non-bank credit facilities and exposures – including those embedded in derivatives – that are originated, renewed or reviewed by HSBC's operating companies in excess of designated limits, prior to the facilities being committed to customers or transactions being undertaken. Operating companies may not confirm credit approval without this concurrence.
- Monitoring the performance and management of retail portfolios across the Group and reviewing whether any adverse trends are being managed appropriately by Group businesses.
- Controlling centrally exposures to sovereign entities, banks and other financial institutions. HSBC's credit and settlement risk limits to counterparties in these sectors are approved centrally and globally managed by a dedicated unit within Group Credit and Risk, to optimise the use of credit availability and avoid excessive risk concentration.
- Managing exposures to debt securities by establishing controls in respect of the liquidity of securities held for trading purposes and setting issuer limits for securities not held for trading. Separate portfolio limits are established for asset-backed securities and similar instruments.
- Maintaining HSBC's policy on large credit exposures, controlling these to ensure that exposure to any individual counterparty or group of closely related counterparties, or to individual geographic areas or industry sectors, does not become excessive in relation to the Group's capital base and is kept within internal and regulatory limits. The approach is designed to be more conservative than internationally accepted regulatory standards. A dedicated unit within Group Credit and Risk manages this process, and also monitors HSBC's intra-Group exposures to ensure that they are maintained within regulatory limits. The FSA has announced changes to the regime for managing intra-Group exposures, which will operate by reference to a [UK Integrated Group](#) and [Wider Integrated Group](#). HSBC is developing plans to adopt the new regime in accordance with the FSA's transition timetable.
- Controlling cross-border exposures, through the imposition of country limits with sub-limits by maturity and type of business. Country limits are determined by taking into account economic and political factors, and

applying local business knowledge. Transactions with countries deemed to be high risk are considered case by case.

- Maintaining and developing HSBC's risk ratings in order to categorise exposures

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: The Management of Risk (continued)*Credit risk > Credit risk management*

meaningfully and facilitate focused management of the attendant risks. Historically, HSBC's risk rating framework has consisted of a minimum of seven grades, taking into account the risk of default and the availability of security or other credit risk mitigation. A more sophisticated risk-rating framework for banks and other customers, based on default probability and loss estimates and comprising up to 22 categories, is now used in all major business units for the credit assessment of individually significant customers. It is increasingly being used for credit portfolio reporting at subsidiary level; work continues on integrating the framework into reporting structures to enable Board and external reporting on the new basis in 2008. This approach allows a more granular analysis of risk and trends. Rating methodology is based upon a wide range of financial analytics together with market data-based tools which are core inputs to the assessment of counterparty risk. Although automated risk-rating processes are increasingly in use, for the larger facilities ultimate responsibility for setting risk grades rests in each case with the final approving executive.

- Reviewing the performance and effectiveness of operating companies' credit approval processes Regular reports are provided to Group Credit and Risk on the credit quality of local portfolios and corrective action is taken where necessary.
- Reporting to senior executives on aspects of the HSBC credit risk portfolio. These executives, as well as the Risk Management Meeting, the Group Audit Committee and the Board of Directors of HSBC Holdings, receive a variety of regular reports covering:
 - risk concentrations and exposure to market sectors;
 - large customer group exposures;
 - retail portfolio performance on a regional basis;
 - specific segments of the portfolio, e.g. real estate, banks, and the automotive and hedge fund sectors, as well as ad hoc reviews;
 - emerging market debt and impairment allowances;
 - large impaired accounts and impairment allowances;
 - country limits, cross-border exposures and impairment allowances; and
 - causes of unexpected loss and lessons to be learned.
- Managing and directing credit risk management systems initiatives. HSBC has a centralised database of large corporate, sovereign and bank facilities and is constructing a database covering all the Group's credit assets. A systems-based credit application process for bank lending is operational throughout the Group and an electronic corporate credit application system is deployed in all of the Group's major businesses.
- Providing advice and guidance to HSBC's operating companies in order to promote best practice throughout the Group on credit-related matters such as:
 - regulatory developments;

- implementing environmental and social responsibility policies;
 - risk modelling;
 - collective impairment allowances;
 - new products;
 - training courses; and
 - credit risk reporting.
- Acting on behalf of HSBC Holdings as the primary interface, for credit-related issues, with external parties including the Bank of England, the FSA, rating agencies, corporate analysts, trade associations and counterparts in the world's major banks and non-bank financial institutions.

Each operating company is required to implement credit policies, procedures and lending guidelines which conform to HSBC Group standards, with credit approval authorities delegated from the Board of Directors of HSBC Holdings to the relevant Chief Executive Officer. In each major subsidiary, management includes a Chief Credit Officer or Chief Risk Officer who reports to the local Chief Executive Officer on credit-related issues and has a functional reporting line to the Group General Manager, Group Credit and Risk. Each operating company is responsible for the quality and performance of its credit portfolios and for monitoring and controlling all credit risks in its portfolios, including those subject to central approval by Group Credit and Risk. This includes managing its own risk concentrations by market sector, geography and product. Local systems are in place throughout the Group to enable operating companies to control and monitor exposures by customer and retail product segments.

[Back to Contents](#)

Special attention is paid to problem loans. When appropriate, specialist units are established by HSBC's operating companies to provide customers with support in order to help them avoid default wherever possible.

Periodic risk-based audits of operating companies' credit processes and portfolios are undertaken by HSBC's Internal Audit function. Audits include a consideration of the completeness and adequacy of credit manuals and lending guidelines; an in-depth analysis of a representative sample of accounts; an overview of homogeneous portfolios of similar assets to assess the quality of the loan book and other exposures; a consideration of any oversight or review work performed by Credit and Risk functions; review of model validation procedures; review of management objectives and a check that Group and local standards and policies are adhered to in the granting and management of credit facilities. Individual accounts are reviewed on a sample basis to ensure that risk grades are appropriate, that credit and collection procedures have been properly followed and that, when an account or portfolio evidences deterioration, impairment allowances are raised in accordance with the Group's established processes. Internal Audit discusses with management risk ratings it considers to be inappropriate; its subsequent recommendations for revised grades must then normally be adopted.

Collateral and other credit enhancements
(Audited)

Loans and advances

It is HSBC's policy to establish that loans are within the customer's capacity to repay, rather than to rely excessively on security. Depending on the customer's standing and the type of product, facilities may be unsecured. Nevertheless, collateral can be an important mitigant of credit risk.

When appropriate, operating companies are required to implement guidelines on the acceptability of specific classes of collateral or credit risk mitigation, and determine suitable valuation parameters. Such parameters are expected to be conservative, reviewed regularly and supported by empirical evidence. Security structures and legal covenants are required to be subject to regular review to ensure that they continue to fulfil their intended purpose and remain in line with local market practice. The principal collateral types are as follows:

- in the personal sector, mortgages over residential properties;
- in the commercial and industrial sector, charges over business assets such as premises, stock and debtors;
- in the commercial real estate sector, charges over the properties being financed;
- in the financial sector, charges over financial instruments such as debt securities and equities in support of trading facilities; and
- credit derivatives are also used to manage credit risk in the Group's loan portfolio, but are not significant.

Other financial assets

Collateral held as security for financial assets other than loans and advances is determined by the nature of the instrument. Debt securities, treasury and other eligible bills are generally unsecured with the exception of asset backed securities and similar instruments, which are secured by pools of financial assets.

The ISDA Master Agreement is HSBC's preferred agreement for documenting derivatives activity. It provides the contractual framework within which dealing activity across a full range of over-the-counter products is conducted, and contractually binds both parties to apply close-out netting across all outstanding transactions covered by an agreement if either party defaults or other pre-agreed termination events occur. It is common, and HSBC's preferred practice, for the parties to execute a Credit Support Annex (CSA) in conjunction with the ISDA Master Agreement. Under a CSA, collateral is passed between the parties to mitigate the market-contingent counterparty risk inherent in the outstanding positions.

Settlement risk arises in any situation where a payment in cash, securities or equities is made in the expectation of a corresponding receipt in cash, securities or equities. Daily settlement limits are established for

each counterparty to cover the aggregate of all settlement risk arising from HSBC's investment banking and markets transactions on any single day. Settlement risk on many transactions, particularly those involving securities and equities, is substantially mitigated when effected via assured payment systems, or on a delivery versus payment basis.

Credit quality of loans and advances
(Audited)

HSBC's credit risk rating processes are designed to highlight exposures which require closer management attention because of their greater probability of default and potential loss. Risk ratings

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: The Management of Risk (continued)

Credit risk > Credit risk management

are reviewed regularly and amendments, where necessary, are implemented promptly.

The credit quality of unimpaired loans is assessed by reference to the Group's standard credit rating system.

Grades 1 and 2 include corporate facilities demonstrating financial condition, risk factors and capacity to repay that are good to excellent, residential mortgages with low to moderate loan to value ratios and other retail accounts which are maintained within product guidelines.

Grade 3 represents satisfactory risk, and includes corporate facilities that require closer monitoring, mortgages with higher loan to value ratios, credit card exposures and other retail exposures which operate outside product guidelines without being impaired.

Grades 4 and 5 include facilities that require varying degrees of special attention and all retail exposures that are progressively between 30 and 90 days past due.

Grades 6 and 7 relate to impaired loans and advances.

Impaired loans and advances

For individually assessed accounts, loans are treated as impaired as soon as there is objective evidence that an impairment loss has been incurred. The criteria used by HSBC to determine that there is such objective evidence include, *inter alia*:

- known cash flow difficulties experienced by the borrower;
- overdue contractual payments of either principal or interest;
- breach of loan covenants or conditions;
- the probability that the borrower will enter bankruptcy or other financial realisation; and
- a significant downgrading in credit rating by an external credit rating agency.

For accounts in portfolios of homogeneous loans, impairment allowances are calculated on a collective basis, as set out below.

Impairment assessment
(Audited)

It is HSBC's policy that each operating company make allowance for impaired loans promptly and on a consistent basis.

Management regularly evaluates the adequacy of the established allowances for impaired loans by conducting a detailed review of the loan portfolio, comparing performance and delinquency statistics with historical trends and assessing the impact of current economic conditions.

Two types of impairment allowance are in place: individually assessed and collectively assessed. These are discussed below.

Individually assessed impairment allowances

These are determined by evaluating the exposure to loss, case by case, on all individually significant accounts and all other accounts that do not qualify for the collective assessment approach outlined below. In determining allowances on individually assessed accounts, the following factors are considered:

- HSBC's aggregate exposure to the customer;
- the viability of the customer's business model and their capacity to trade successfully out of financial difficulties, generating sufficient cash flow to service debt obligations;
- the ability of the borrower to obtain, and make payments in, the currency of the loan if not denominated in local currency;
- the amount and timing of expected receipts and recoveries;
- the extent of other creditors' commitments ranking ahead of, or *pari passu* with, HSBC and the likelihood of other creditors continuing to support the company;
- the complexity of determining the aggregate amount and ranking of all creditor claims and the extent to which legal and insurance uncertainties are evident;
- the realisable value of security (or other credit mitigants) and likelihood of successful repossession;
- the likely dividend available on liquidation or bankruptcy;
- the likely deduction of any costs involved in recovering amounts outstanding, and
- when available, the secondary market price of the debt.

Group policy requires the level of impairment allowances on individual facilities that are above materiality thresholds to be reviewed at least semi-annually, and more regularly when individual circumstances require. The review normally

[Back to Contents](#)

encompasses collateral held (including re-confirmation of its enforceability) and an assessment of actual and anticipated receipts. For significant commercial and corporate debts, specialised loan [work-out] teams with experience in insolvency and specific market sectors are used to assess likely losses on significant individual exposures. Individually assessed impairment allowances are only reversed when the Group has reasonable and objective evidence of a reduction in the established loss estimate.

Collectively assessed impairment allowances

Impairment is assessed on a collective basis in two circumstances:

- to cover losses which have been incurred but have not yet been identified on loans subject to individual assessment; and
- for homogeneous groups of loans that are not considered individually significant.

Incurred but not yet identified impairment

Individually assessed loans for which no evidence of impairment has been specifically identified on an individual basis are grouped together according to their credit risk characteristics. A collective loan loss allowance is calculated to reflect impairment losses incurred at the balance sheet date which will only be individually identified in the future.

The collective impairment allowance is determined having taken into account:

- historical loss experience in portfolios of similar credit risk characteristics (for example, by industry sector, risk rating or product segment);
- the estimated period between impairment occurring and the loss being identified and evidenced by the establishment of an appropriate allowance against the individual loan; and
- management's experienced judgement as to whether current economic and credit conditions are such that the actual level of inherent losses is likely to be greater or less than that suggested by historical experience.

The period between a loss occurring and its identification is estimated by local management for each identified portfolio. In general, the periods used vary between four and twelve months although, in exceptional cases, longer periods are warranted.

The basis on which impairment allowances for incurred but not yet identified losses is established in

each reporting entity is documented and reviewed by senior Group Credit and Risk management to ensure conformity with Group policy.

Homogeneous groups of loans

Two methodologies are used to calculate impairment allowances where large numbers of relatively low-value assets are managed using a portfolio approach, typically:

- low-value, homogeneous small business accounts in certain countries or territories;
- residential mortgages that have not been individually assessed;
- credit cards and other unsecured consumer lending products; and
- motor vehicle financing.

When appropriate empirical information is available, the Group uses roll rate methodology. This employs a statistical analysis of historical trends of default and the amount of consequential loss, based on the delinquency of accounts within a portfolio of homogeneous accounts. Other historical data and current economic conditions are also evaluated when calculating the appropriate level of impairment allowance required to cover inherent loss. In certain highly developed markets, models also take into account behavioural and account management trends revealed in, for example, bankruptcy and rescheduling statistics.

When the portfolio size is small, or when information is insufficient or not reliable enough to adopt a roll rate methodology, a formulaic approach is used which allocates progressively higher percentage loss rates the longer a customer's loan is overdue. Loss rates reflect the discounted expected future cash flows for a portfolio.

In normal circumstances, historical experience is the most objective and relevant information from which to assess inherent loss within each portfolio. In circumstances where historical loss experience provides less relevant information about the inherent loss in a given portfolio at the balance sheet date – for example, where there have been changes in economic conditions or regulations – management considers the more recent trends in the portfolio risk factors which may not be adequately reflected in its statistical models and, subject to guidance from Group Credit and Risk, adjusts impairment allowances accordingly.

Roll rates, loss rates and the expected timing of future recoveries are regularly benchmarked against actual outcomes to ensure they remain appropriate.

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: The Management of Risk (continued)

Credit risk > Credit risk management / Exposure

Collectively assessed allowances are generally calculated monthly and charges for new allowances, or reversals of existing allowances, are determined for each separately identified portfolio.

Impairment allowances

When impairment losses occur, HSBC reduces the carrying amount of loans and advances and held-to-maturity financial investments through the use of an allowance account. When impairment of available-for-sale financial assets occurs, the carrying amount of the asset is reduced directly.

Loan write-offs

Loans, and the related impairment allowances, are normally written off, either partially or in full, in the case of that portion of the loan amount not covered by the value of security, when there is no realistic prospect of further recovery; and in the case of secured balances, after proceeds from the realisation of security have been received. Unsecured consumer facilities are normally written off between 150 and 210 days overdue. In HSBC Finance, this period is generally extended to 300 days overdue (240 days for real estate secured products).

Instances of write-off periods exceeding 360 days overdue are few, but can arise where certain consumer finance accounts are deemed collectible beyond this point or where, in a few countries, regulation or legislation constrain earlier write-off.

In the event of bankruptcy, or analogous proceedings, write-off can occur earlier.

Cross-border exposures

Management assesses the vulnerability of countries to foreign currency payment restrictions when considering impairment allowances on cross-border exposures. This assessment includes an analysis of the economic and political factors existing at the time. Economic factors include the level of external indebtedness, the debt service burden and access to external sources of funds to meet the debtor country's financing requirements. Political factors taken into account include the stability of the country and its government, threats to security, and the quality and independence of the legal system.

Impairment allowances are applied to all qualifying exposures within these countries unless these exposures and the inherent risks are:

- performing, trade-related and of less than one year's maturity;
- mitigated by acceptable security cover which is, other than in exceptional cases, held outside the country concerned;
- in the form of securities held for trading purposes for which a liquid and active market exists, and which are measured at fair value daily;
- performing facilities with principal (excluding security) of US\$1 million or below; or
- performing facilities with maturity dates shorter than three months.

Credit exposure

Maximum exposure to credit risk
(Audited)

Factors which had a direct impact on changes in HSBC's maximum exposure to credit risk during 2006 related to the curtailment of growth in mortgage lending in the US in response to deteriorating conditions, and slowed growth in UK personal unsecured lending following an increase in personal bankruptcies and IVAs. Elsewhere, growth reflected underlying economic trends on a geographic basis.

The following table presents the maximum exposure to credit risk of balance sheet and off balance sheet financial instruments, before taking account of any collateral held or other credit enhancements unless such credit enhancements meet offsetting requirements as set out in Note 2(m) on the Financial Statements. For financial assets recognised on the balance sheet, the exposure to credit risk equals their carrying amount. For financial guarantees granted, the maximum exposure to credit risk is the maximum amount that HSBC would have to pay if the guarantees are called upon. For loan commitments and other credit related commitments that are irrevocable over the life of the respective facilities, the maximum exposure to credit risk is the full amount of the committed facilities.

[Back to Contents](#)**Maximum exposure to credit risk***(Audited)*

	Maximum exposure	
	2006	2005
	US\$m	US\$m
Items in course of collection from other banks	14,144	11,300
Trading assets	300,998	212,706
Treasury and other eligible bills	21,759	12,746
Debt securities	155,447	117,659
Loans and advances	123,792	82,301
Financial assets designated at fair value	9,971	6,513
Treasury and other eligible bills	133	53
Debt securities	9,449	5,705
Loans and advances	389	755
Derivatives	103,702	73,928
Loans and advances to banks	185,205	125,965
Loans and advances to customers	868,133	740,002
Financial investments	196,509	174,823
Treasury and other eligible bills	25,313	25,042
Debt securities	171,196	149,781
Other assets	22,846	18,954
Endorsements and acceptances	9,577	7,973
Other	13,269	10,981
Financial guarantees	62,014	66,805
Loan commitments and other credit related commitments ¹	714,630	654,343
At 31 December	2,478,152	2,085,339

1 *The amount of the loan commitments shown above reflects, where relevant, the expected level of take-up of pre-approved loan offers made by mailshots to personal customers. In addition to those amounts, there is a further maximum possible exposure to credit risk of US\$464,984 million (2005: US\$313,629 million), reflecting the full take-up of such irrevocable loan commitments. The take-up of such offers is generally at modest levels. 2005 data have also been adjusted to ensure consistency with 2006 data for this disclosure.*

Concentration of exposure*(Audited)*

Concentrations of credit risk exist when a number of counterparties are engaged in similar activities, or operate in the same geographical areas or industry sectors and have similar economic characteristics so that their ability to meet contractual obligations is similarly affected by changes in economic, political or other conditions.

Loans and advances*(Unaudited)*

Loans and advances were well spread across both industry sectors and jurisdictions.

At constant exchange rates, gross loans and advances to customers (excluding the finance sector and settlement accounts) grew by US\$82 billion or 11 per cent during 2006. On the same basis, personal lending comprised 58 per cent of HSBC's loan portfolio and 47 per cent of the growth in loans in 2006.

Including the financial sector and settlement accounts, personal lending represented US\$476 billion, or 54 per cent, of total loans and advances to customers at 31 December 2006. Within this total, residential mortgages were US\$265 billion

and, at 30 per cent of total advances to customers, were the Group's largest single sectoral concentration.

Corporate, commercial and financial lending, including settlement accounts, comprised 46 per cent of gross lending to customers at 31 December 2006. The largest single industry concentrations were in non-bank financial institutions and commercial real estate lending, each of which amounted to 7 per cent of total gross lending to customers, broadly in line with 2005.

Commercial, industrial and international trade lending grew strongly in 2006, notably to the service industry. This increased this class of lending by a percentage point to 18 per cent of total gross loans and advances to customers. Within this category the largest concentration of lending was to the service industry, which amounted to just over 5 per cent of total gross lending to customers.

Advances to banks were widely distributed, principally to major institutions, and with no single exposure more than 5 per cent of total advances to banks.

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: The Management of Risk

Credit risk > Exposure > 2006

Financial investments

(Unaudited)

At US\$205 billion, total financial investments were 12 per cent higher than at the end of 2005. Investments of US\$93 billion in corporate debt and other securities were the largest single concentration of these assets, representing 46 per cent of overall investments, compared with 53 per cent at 31 December 2005. HSBC's holdings of corporate debt, asset-backed securities and other securities were spread across a wide range of issuers and geographical regions, with 72 per cent invested in securities issued by banks and other financial institutions.

Investments in governments and government agencies of US\$76 billion were 37 per cent of overall financial investments, 4 percentage points lower than in 2005. One third of these investments were held in treasury and other eligible bills.

The insurance businesses had a diversified portfolio of debt and equity securities designated at fair value (US\$18 billion) and debt securities classified as financial investments (US\$10 billion).

Securities held for trading

(Unaudited)

Total securities held for trading within trading assets were US\$204 billion. The largest concentration of these assets was government and government agency securities, which amounted to US\$94 billion, or 46 per cent of overall trading securities. This included US\$22 billion of treasury and other eligible bills. Corporate debt and other securities were US\$67 billion or 33 per cent of overall trading securities, 4 percentage points lower than in 2005. Included within this were US\$36 billion of debt securities issued by banks and other financial institutions.

Gross loans and advances by industry sector

(Unaudited)

	At 31 December 2005 US\$m	Constant currency effect US\$m	Movement on a constant currency basis US\$m	At 31 December 2006 US\$m
Loans and advances to customers				
Personal:				
Residential mortgages ¹	238,546	11,036	15,755	265,337
Other personal ²	181,930	6,294	22,585	210,809
Total personal	420,476	17,330	38,340	476,146

Corporate and commercial:				
Commercial, industrial and international trade	130,802	10,887	20,420	162,109
Commercial real estate	51,815	3,158	5,393	60,366
Other property-related	22,196	1,150	3,819	27,165
Government	8,218	191	581	8,990
Other commercial ³	65,678	5,828	12,971	84,477
	<hr/>	<hr/>	<hr/>	<hr/>
Total corporate and commercial	278,709	21,214	43,184	343,107
Financial:				
Non-bank financial institutions	50,032	4,698	4,474	59,204
Settlement accounts	2,142	82	1,030	3,254
	<hr/>	<hr/>	<hr/>	<hr/>
Total financial	52,174	4,780	5,504	62,458
	<hr/>	<hr/>	<hr/>	<hr/>
Total loans and advances to customers	751,359	43,324	87,028	881,711
Loans and advances to banks	125,974	5,953	53,285	185,212
	<hr/>	<hr/>	<hr/>	<hr/>
Total gross loans and advances	877,333	49,277	140,313	1,066,923
	<hr/>	<hr/>	<hr/>	<hr/>

- 1 Includes Hong Kong Government Home Ownership Scheme loans (US\$4,078 million at 31 December 2006).
- 2 Other personal loans and advances include second lien mortgages and other property-related lending.
- 3 Other commercial loans and advances include advances in respect of agriculture, transport, energy and utilities.

Year ended 31 December 2006 compared with year ended 31 December 2005
(Unaudited)

The commentary below analyses the movement in lending on a constant currency basis noted in the table above compared with the position at

31 December 2005. On this basis, total loans and advances to customers grew by 11 per cent and gross loans and advances increased by 15 per cent.

Geographically, total lending to personal customers was dominated by the diverse portfolios in North America (US\$232 billion), the UK

[Back to Contents](#)

(US\$129 billion) and Hong Kong (US\$39 billion). Collectively, these lending books accounted for 84 per cent of total lending to the personal sector, 3 percentage points lower than the 87 per cent level reported at 31 December 2005.

Residential mortgages rose by US\$16 billion, or 6 per cent, to US\$265 billion, representing 30 per cent of total gross loans to customers at 31 December 2006. Residential mortgages include only first lien secured loans. In value terms, growth was greatest in the UK, where residential mortgages increased by 7 per cent to US\$83 billion, and in North America, where mortgage balances rose by 6 per cent to US\$124 billion. In the US, mortgage balances within HSBC Finance increased by 13 per cent to US\$76 billion. In Hong Kong, mortgage balances rose by 1 per cent.

In North America, growth in residential mortgage balances was attributable both to increases in non-prime lending originated through the branch-based consumer lending business and balances acquired from correspondent brokers and banks through the mortgage services business.

In light of emerging evidence of unforeseen deterioration within the US mortgage services business in respect of originations made in 2005 and the first half of 2006, a wide range of initiatives was implemented to mitigate the impact on the affected portions of the business. Consequently, in the second half of the year, growth in real estate lending slowed, as the mortgage services business tightened its underwriting criteria, as detailed on page 189. Prime mortgage balances held in the US banking network also declined, as HSBC sold the majority of its new prime mortgage originations into the secondary market and increased its securitisation programme, which together augmented the normal run-off of balances. In Canada, mortgage balances rose, primarily due to a strong housing market and continued expansion of HSBC's consumer finance business and core banking distribution channels.

In the UK, mortgage balances rose by 7 per cent, primarily in the form of fixed rate mortgages as customers sought to insulate themselves from rising interest rates. Mortgage lending in France experienced strong growth, benefiting from competitive pricing and a marked improvement in brand awareness following the rebranding of the business in 2005.

Residential mortgage balances in Hong Kong rose as increased marketing and product development contributed to HSBC raising its market share. This occurred despite a subdued housing

market, fierce competition and continuing reduction in assets from the suspended GHOS.

In the Rest of Asia-Pacific, mortgage balances fell by 6 per cent, as the sale of the broker-originated mortgage business in Australia offset modest growth in most other countries.

Other personal lending grew by 12 per cent to US\$211 billion at 31 December 2006, representing 24 per cent of gross loans and advances to customers.

In North America, growth in other personal lending was largely driven by credit card activity and increased second lien mortgage balances. In the US, increased uptake of both prime and non-prime credit cards was driven by targeted marketing campaigns and the launch of several new co-branded cards. The credit card market continued to be highly competitive with many competitors relying on zero per cent offers to generate growth. HSBC, by contrast, reduced the amount of its equivalent offers and focused instead on increased marketing. In the first half of 2006, the US mortgage services business significantly increased the levels of second lien mortgages, continuing the growth of this loan type that was instigated in 2005. The rate of growth of the second lien mortgage book slowed in the latter half of the year as the deterioration of credit quality of the portfolio became apparent. This is discussed in further detail under mortgage lending in the US on page 189. The US motor vehicle finance portfolio also grew, due to increased volumes in both the dealer network and the consumer direct loan programme, dampened by the expiration of fixed-term loans and reduction in the level of incentives offered by car manufacturers.

Other personal lending grew by 10 per cent in Europe. In the UK, unsecured personal loan balances declined, reflecting a policy decision to constrain growth to selected segments by tightening underwriting criteria. Credit

card balances increased, driven by promotional and marketing campaigns, with strong growth in M&S branded credit cards. In Turkey, unsecured personal lending grew strongly reflecting the success of marketing initiatives and cross-sales with existing credit card clients.

Promotional and marketing activity contributed towards a strengthening of HSBC's position as the largest credit card issuer in Hong Kong, with over 4.6 million cards in force.

In the Rest of Asia-Pacific, other personal lending rose by 15 per cent. Credit card balances grew rapidly with an increase of over 1.2 million cards in circulation in 2006 following new product

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: The Management of Risk (continued)

Credit risk > Exposure > 2006 / By industry sector

launches in the Middle East, Sri Lanka and Singapore and marketing and incentive campaigns across the region. Other unsecured lending balances rose during 2006, partly as a result of expansion of HSBC's consumer finance business in India, Australia and Indonesia.

In Latin America, other personal lending showed significant growth, rising by 49 per cent, with cross-sales of the "Tu Cuenta" product generating strong demand for credit cards in Mexico. Personal lending balances, excluding mortgages, rose by 25 per cent in Brazil, with increased vehicle finance lending benefiting from strengthened relationships with car dealers, and higher numbers of credit cards in issue following a number of campaigns designed to improve retention and utilisation.

Loans and advances to corporate and commercial customers grew by 14 per cent to US\$343 billion. Lending was primarily in Europe, which accounted for 57 per cent of advances, over three quarters of which was concentrated in the UK.

In Europe, corporate and commercial advances rose by 9 per cent, driven by lending growth in the UK, France and Turkey. In the UK, there was firm growth in lending to the service industry and real estate and related construction businesses. In France, improved retention of existing clients and recruitment of new customers resulted in higher lending balances, while in Turkey expansion of the branch network, including dedicated SME centres, contributed to growth in commercial advances.

In Hong Kong there was strong demand for credit from larger Commercial Banking customers in the property sector and from manufacturers with

operations in mainland China seeking to fund expansion. New initiatives designed to increase commercial lending included a pre-approved lending scheme and a telesales campaign, which led to growth in SME lending and a doubling in the number of lending relationships in this segment. This strong growth in Commercial Banking lending was offset by the repayment of two large facilities by Corporate, Investment Banking and Markets clients.

In the Rest of Asia-Pacific, strong economic expansion in the Middle East led to greater demand for credit and regional lending balances rose in response to increases in regional trade flows and increased marketing activity.

In North America, expansion into new regional markets, higher levels of marketing and the recruitment of additional SME relationship managers to meet customer demand contributed to growth in corporate and commercial lending balances.

HSBC experienced strong growth in lending balances to SME businesses across Latin America due to favourable economic conditions.

Additionally, in Mexico, strong demand for credit from the rapidly growing real estate and residential construction sectors contributed to greater levels of lending.

The following tables analyse loans and advances by industry sector and by the location of the principal operations of the lending subsidiary or, in the case of the operations of The Hongkong and Shanghai Banking Corporation, HSBC Bank, HSBC Bank Middle East and HSBC Bank USA, by the location of the lending branch.

[Back to Contents](#)

Loans and advances to customers by industry sector and by geographical region
(Audited)

At 31 December 2006

	Europe US\$m	Hong Kong US\$m	Rest of Asia- Pacific US\$m	North America US\$m	Latin America US\$m	Gross loans and advances to customers US\$m	Gross loans by industry sector as a % of total gross loans %
Personal							
Residential mortgages ¹	91,534	28,743	17,478	123,955	3,627	265,337	30.1
Other personal	67,214	10,396	13,275	108,256	11,668	210,809	23.9
	<u>158,748</u>	<u>39,139</u>	<u>30,753</u>	<u>232,211</u>	<u>15,295</u>	<u>476,146</u>	<u>54.0</u>
Corporate and commercial							
Commercial, industrial and international trade	99,027	16,845	25,196	11,004	10,037	162,109	18.4
Commercial real estate	28,655	12,481	5,502	12,782	946	60,366	6.8
Other property-related	9,616	6,923	3,491	5,931	1,204	27,165	3.1
Government	2,360	551	1,916	220	3,943	8,990	1.0
Other commercial ²	56,650	5,553	8,468	9,736	4,070	84,477	9.6
	<u>196,308</u>	<u>42,353</u>	<u>44,573</u>	<u>39,673</u>	<u>20,200</u>	<u>343,107</u>	<u>38.9</u>
Financial							
Non-bank financial institutions	40,055	2,332	2,926	12,258	1,633	59,204	6.7
Settlement accounts	1,064	823	223	1,092	52	3,254	0.4
	<u>41,119</u>	<u>3,155</u>	<u>3,149</u>	<u>13,350</u>	<u>1,685</u>	<u>62,458</u>	<u>7.1</u>
Total gross loans and advances to customers ³	<u>396,175</u>	<u>84,647</u>	<u>78,475</u>	<u>285,234</u>	<u>37,180</u>	<u>881,711</u>	<u>100.0</u>
Percentage of Group loans and advances by geographical region							
	44.9%	9.6%	8.9%	32.4%	4.2%	100.0%	
Impaired loans							
	5,847	454	1,184	4,822	1,478	13,785	
Impaired loans as a percentage of gross loans and advances to customers							
	1.5%	0.5%	1.5%	1.7%	4.0%	1.6%	
Impairment allowances outstanding against loans and advances ⁴							
	3,676	365	901	7,247	1,389	13,578	
Impairment allowances outstanding as a							
	62.9%	80.4%	76.1%	150.3%	94.0%	98.5%	

percentage of impaired
loans⁴

- 1 *Includes Hong Kong Government Home Ownership Scheme loans (US\$4,078 million at 31 December 2006).*
- 2 *Other commercial loans and advances include advances in respect of agriculture, transport, energy and utilities.*
- 3 *Included within this total is credit card lending of US\$74,518 million.*
- 4 *Impairment allowances include collective impairment allowances on collectively assessed loans and advances.*

Included in personal lending in North America are the following balances relating to the US:

(Unaudited)

	At 31 December	
	2006	2005
	US\$m	US\$m
Residential mortgages □ HSBC Bank USA	31,589	36,170
Residential mortgages □ HSBC Finance	75,903	67,359
Motor vehicle finance	13,146	12,792
MasterCard/Visa credit cards	29,269	26,795
Private label cards	16,645	15,488
Other unsecured personal lending	41,214	35,545
	207,766	194,149

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: The Management of Risk (continued)

Credit risk > Exposure > By industry sector

Loans and advances to customers by industry sector and by geographical region

(Audited)

At 31 December 2005 (restated⁵)

	Europe US\$m	Hong Kong US\$m	Rest of Asia- Pacific US\$m	North America US\$m	Latin America US\$m	Gross loans and advances to customers US\$m	Gross loans by industry sector as a % of total gross loans %
Personal							
Residential mortgages ¹	73,923	28,492	17,641	116,448	2,042	238,546	31.7
Other personal	55,672	9,978	11,178	97,663	7,439	181,930	24.2
	<u>129,595</u>	<u>38,470</u>	<u>28,819</u>	<u>214,111</u>	<u>9,481</u>	<u>420,476</u>	<u>55.9</u>
Corporate and commercial							
Commercial, industrial and international trade	76,687	16,736	21,286	10,375	5,718	130,802	17.4
Commercial real estate	22,071	12,557	5,081	11,714	392	51,815	6.9
Other property-related	7,603	6,147	3,426	4,447	573	22,196	3.0
Government	1,821	303	2,147	192	3,755	8,218	1.1
Other commercial ²	41,944	6,922	7,716	7,189	1,907	65,678	8.7
	<u>150,126</u>	<u>42,665</u>	<u>39,656</u>	<u>33,917</u>	<u>12,345</u>	<u>278,709</u>	<u>37.1</u>
Financial							
Non-bank financial institutions	35,305	1,966	2,202	9,464	1,095	50,032	6.7
Settlement accounts	1,002	505	175	416	44	2,142	0.3
	<u>36,307</u>	<u>2,471</u>	<u>2,377</u>	<u>9,880</u>	<u>1,139</u>	<u>52,174</u>	<u>7.0</u>
Total gross loans and advances to customers ³	<u>316,028</u>	<u>83,606</u>	<u>70,852</u>	<u>257,908</u>	<u>22,965</u>	<u>751,359</u>	<u>100.0</u>
Percentage of Group loans and advances by geographical region							
Impaired loans	42.1%	11.1%	9.4%	34.3%	3.1%	100.0%	
	5,068	506	936	3,710	1,226	11,446	
	1.6%	0.6%	1.3%	1.4%	5.3%	1.5%	

Impaired loans as a percentage of gross loans and advances to customers						
Impairment allowances outstanding against loans and advances ⁴	3,491	398	836	5,349	1,283	11,357
Impairment allowances outstanding as a percentage of impaired loans ⁴	68.9%	78.7%	89.3%	144.2%	104.6%	99.2%

1 Includes Hong Kong Government Home Ownership Scheme loans (US\$4,680 million at 31 December 2005).

2 Other commercial loans and advances include advances in respect of agriculture, transport, energy and utilities.

3 Included within this total is credit card lending of US\$66,020 million.

4 Impairment allowances include collective impairment allowances on collectively assessed loans and advances.

5 In 2006, Mexico and Panama were reclassified from the North America segment to the Latin America segment. Comparative information has been restated accordingly. See Note 13 on the Financial Statements.

[Back to Contents](#)

(Unaudited)

At 31 December 2004 (restated⁶)

	Europe US\$m	Hong Kong US\$m	Rest of Asia- Pacific US\$m	North America US\$m	Latin America US\$m	Gross loans and advances to customers US\$m	Gross loans by industry sector as a % of total gross loans %
Personal							
Residential mortgages ¹	70,546	29,373	14,860	111,455	1,613	227,847	33.3
Other personal	57,920	9,105	9,079	78,984	4,917	160,005	23.3
	<u>128,466</u>	<u>38,478</u>	<u>23,939</u>	<u>190,439</u>	<u>6,530</u>	<u>387,852</u>	<u>56.6</u>
Corporate and commercial							
Commercial, industrial and international trade	55,018	14,132	19,177	9,544	4,005	101,876	14.9
Commercial real estate	18,917	10,388	4,232	9,712	220	43,469	6.3
Other property-related	6,850	5,959	3,350	4,266	324	20,749	3.0
Government	3,663	615	1,432	1,174	3,643	10,527	1.5
Other commercial ²	34,185	7,294	7,015	5,173	1,484	55,151	8.1
	<u>118,633</u>	<u>38,388</u>	<u>35,206</u>	<u>29,869</u>	<u>9,676</u>	<u>231,772</u>	<u>33.8</u>
Financial							
Non-bank financial institutions	30,901	1,932	2,297	16,624	575	52,329	7.6
Settlement accounts	4,476	596	305	8,431	11	13,819	2.0
	<u>35,377</u>	<u>2,528</u>	<u>2,602</u>	<u>25,055</u>	<u>586</u>	<u>66,148</u>	<u>9.6</u>
Total gross loans and advances to customers³	<u>282,476</u>	<u>79,394</u>	<u>61,747</u>	<u>245,363</u>	<u>16,792</u>	<u>685,772</u>	<u>100.0</u>
Percentage of Group loans and advances by geographical region							
	41.2%	11.6%	9.0%	35.8%	2.4%	100.0%	
Impaired loans ^{4,5}	6,039	696	1,160	3,555	977	12,427	
Impaired loans as a percentage of gross loans and advances ⁴	2.1%	0.9%	1.9%	1.4%	5.8%	1.8%	
Specific provisions outstanding against loans and advances ⁵	4,036	320	785	4,106	770	10,017	
Specific provisions outstanding as a percentage of impaired loans ^{4,5}	66.8%	46.0%	67.7%	115.5%	78.8%	80.6%	

1 Includes Hong Kong Government Home Ownership Scheme loans (US\$5,383 million at 31 December 2004).

2 Other commercial loans and advances include advances in respect of agriculture, transport, energy and utilities.

- 3 *Included within this total is credit card lending of US\$56,222 million.*
- 4 *Net of suspended interest.*
- 5 *Included in North America are impaired loans of US\$3,020 million and specific provisions of US\$3,443 million in HSBC Finance; excluding HSBC Finance, specific provisions outstanding as a percentage of impaired loans was 54.6 per cent.*
- 6 *In 2006, Mexico and Panama were reclassified from the North America segment to the Latin America segment. Comparative information has been restated accordingly. See Note 13 on the Financial Statements.*

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: The Management of Risk (continued)

Credit risk > Exposure > By industry sector

Loans and advances to customers by industry sector and by geographical region (continued)
(Unaudited)At 31 December 2003² (restated⁷)

	Europe US\$m	Hong Kong US\$m	Rest of Asia- Pacific US\$m	North America US\$m	Latin America US\$m	Gross loans and advances to customers US\$m	Gross loans by industry sector as a % of total gross loans %
Personal							
Residential mortgages ¹	51,721	29,954	12,101	76,485	1,493	171,754	31.6
Other personal	42,041	7,420	7,135	73,717	3,832	134,145	24.7
	<u>93,762</u>	<u>37,374</u>	<u>19,236</u>	<u>150,202</u>	<u>5,325</u>	<u>305,899</u>	<u>56.3</u>
Corporate and commercial							
Commercial, industrial and international trade	49,468	10,966	14,892	7,265	3,077	85,668	15.7
Commercial real estate	15,517	8,548	3,149	7,699	175	35,088	6.5
Other property-related	5,416	5,075	2,597	3,850	202	17,140	3.2
Government	2,462	927	1,450	375	4,376	9,590	1.8
Other commercial ³	24,239	6,754	5,735	5,682	1,620	44,030	8.1
	<u>97,102</u>	<u>32,270</u>	<u>27,823</u>	<u>24,871</u>	<u>9,450</u>	<u>191,516</u>	<u>35.3</u>
Financial							
Non-bank financial institutions	21,226	4,921	2,027	8,588	329	37,091	6.8
Settlement accounts	3,068	556	188	4,767	15	8,594	1.6
	<u>24,294</u>	<u>5,477</u>	<u>2,215</u>	<u>13,355</u>	<u>344</u>	<u>45,685</u>	<u>8.4</u>
Total gross loans and advances to customers⁴	<u>215,158</u>	<u>75,121</u>	<u>49,274</u>	<u>188,428</u>	<u>15,119</u>	<u>543,100</u>	<u>100.0</u>
Percentage of Group loans and advances by geographical region	39.6%	13.8%	9.1%	34.7%	2.8%	100.0%	
Non-performing loans⁶	5,701	1,671	1,538	4,889	1,251	15,050	
	2.6%	2.2%	3.1%	2.6%	8.3%	2.8%	

Non-performing loans as a percentage of gross loans and advances to customers⁵

Specific provisions outstanding against loans and advances ⁶	3,554	629	981	4,660	1,054	10,878
Specific provisions outstanding as a percentage of non-performing loans ⁶	62.3%	37.6%	63.8%	95.3%	84.3%	72.3%

1 Includes Hong Kong Government Home Ownership Scheme loans (US\$6,290 million at 31 December 2003).

2 Figures presented in this table were prepared in accordance with UK GAAP.

3 Other commercial loans and advances include advances in respect of agriculture, transport, energy and utilities.

4 Included within this total is credit card lending of US\$48,634 million.

5 Net of suspended interest.

6 Included in North America are non-performing loans of US\$4,335 million and specific provisions of US\$4,448 million in HSBC Finance; excluding HSBC Finance, specific provisions outstanding as a percentage of non-performing loans was 69.2 per cent.

7 In 2006, Mexico and Panama were reclassified from the North America segment to the Latin America segment. Comparative information has been restated accordingly. See Note 13 on the Financial Statements.

[Back to Contents](#)

(Unaudited)

At 31 December 2002² (restated⁶)

	Europe US\$m	Hong Kong US\$m	Rest of Asia- Pacific US\$m	North America US\$m	Latin America US\$m	Gross loans and advances to customers US\$m	Gross loans by industry sector as a % of total gross loans %
Personal							
Residential mortgages ¹	38,719	31,094	7,507	25,127	1,792	104,239	28.9
Other personal	26,748	7,066	5,900	6,514	2,334	48,562	13.4
	<u>65,467</u>	<u>38,160</u>	<u>13,407</u>	<u>31,641</u>	<u>4,126</u>	<u>152,801</u>	<u>42.3</u>
Corporate and commercial							
Commercial, industrial and international trade	44,424	10,173	12,582	8,706	3,130	79,015	21.8
Commercial real estate	11,887	8,336	2,701	6,158	185	29,267	8.1
Other property-related	3,970	4,805	2,031	4,250	291	15,347	4.2
Government	2,164	719	933	446	4,691	8,953	2.5
Other commercial ³	22,712	6,612	5,950	3,925	1,475	40,674	11.2
	<u>85,157</u>	<u>30,645</u>	<u>24,197</u>	<u>23,485</u>	<u>9,772</u>	<u>173,256</u>	<u>47.8</u>
Financial							
Non-bank financial institutions	15,221	2,055	931	8,953	327	27,487	7.6
Settlement accounts	2,622	347	192	5,224	□	8,385	2.3
	<u>17,843</u>	<u>2,402</u>	<u>1,123</u>	<u>14,177</u>	<u>327</u>	<u>35,872</u>	<u>9.9</u>
Total gross loans and advances to customers⁴	<u>168,467</u>	<u>71,207</u>	<u>38,727</u>	<u>69,303</u>	<u>14,225</u>	<u>361,929</u>	<u>100.0</u>
Percentage of Group loans and advances by geographical region	46.5%	19.7%	10.7%	19.2%	3.9%	100.0%	
Non-performing loans ⁵	4,495	1,724	2,055	508	1,741	10,523	
Non-performing loans as a percentage of gross loans and advances to customers ⁵	2.7%	2.4%	5.3%	0.7%	12.2%	2.9%	
Specific provisions outstanding against loans and advances	2,774	688	1,321	222	1,601	6,606	
Specific provisions outstanding as a percentage of non-performing loans ⁵	61.7%	39.9%	64.3%	43.7%	92.0%	62.8%	

1 Includes Hong Kong Government Home Ownership Scheme loans (US\$7,255 million at 31 December 2002).

2 Figures presented in this table were prepared in accordance with UK GAAP.

3 Other commercial loans include advances in respect of agriculture, transport, energy and utilities.

4 Included within this total is credit card lending of US\$9,950 million.

5 Net of suspended interest.

- ⁶ *In 2006, Mexico and Panama were reclassified from the North America segment to the Latin America segment. Comparative information has been restated accordingly. See Note 13 on the Financial Statements.*

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: The Management of Risk (continued)

Credit risk > Exposure > Rest of Asia-Pacific and Latin America /
Banks / Financial assets

Loans and advances to customers by principal area within Rest of Asia-Pacific and Latin America
(Audited)**Loans and advances (gross)**

	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 2006					
Australia and New Zealand	4,493	622	2,472	4,127	11,714
India	1,338	1,067	203	2,363	4,971
Indonesia	17	371	2	1,014	1,404
Japan	18	131	648	2,601	3,398
Mainland China	377	9	1,504	4,226	6,116
Malaysia	2,456	1,277	589	3,537	7,859
Middle East	434	3,134	1,733	10,595	15,896
Singapore	3,090	3,225	1,286	2,052	9,653
South Korea	2,708	862	45	2,655	6,270
Taiwan	2,273	881	15	970	4,139
Thailand	26	385	132	1,043	1,586
Other	248	1,311	364	3,546	5,469
Total of Rest of Asia-Pacific	17,478	13,275	8,993	38,729	78,475
Argentina	22	314	52	1,625	2,013
Brazil	211	6,579	251	5,212	12,253
Mexico	1,801	3,353	959	8,648	14,761
Other	1,593	1,422	888	4,250	8,153
Total of Latin America	3,627	11,668	2,150	19,735	37,180
At 31 December 2005 (restated¹)					
Australia and New Zealand	5,912	694	2,588	3,698	12,892
India	1,139	545	104	1,819	3,607
Indonesia	13	338	8	921	1,280
Japan	14	139	696	2,352	3,201
Mainland China	358	11	1,210	3,426	5,005
Malaysia	2,223	871	496	2,925	6,515
Middle East	258	2,320	1,448	9,403	13,429
Singapore	2,811	3,395	1,441	2,249	9,896
South Korea	2,585	460	31	2,219	5,295
Taiwan	2,094	1,057	14	727	3,892
Thailand	23	220	75	958	1,276
Other	211	1,128	396	2,829	4,564

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Total of Rest of Asia-Pacific	17,641	11,178	8,507	33,526	70,852
Argentina	4	147	31	1,000	1,182
Brazil	187	4,838	206	3,432	8,663
Mexico	1,394	2,289	525	7,503	11,711
Other	457	165	203	584	1,409
Total of Latin America	2,042	7,439	965	12,519	22,965

¹ *In 2006, Mexico and Panama were reclassified from the North America segment to the Latin America segment. Comparative information has been restated accordingly. See Note 13 on the Financial Statements.*

[Back to Contents](#)**Loans and advances to banks by geographical region**

	Europe US\$m	Hong Kong US\$m	Rest of Asia- Pacific US\$m	North America US\$m	Latin America US\$m	Gross loans and advances to banks US\$m	Impairment allowances ² US\$m
At 31 December 2006 <i>(audited)</i> .	76,837	50,359	27,517	17,865	12,634	185,212	(7)
At 31 December 2005 <i>(audited)</i> ¹	44,369	42,751	19,559	10,331	8,964	125,974	(9)
At 31 December 2004 <i>(unaudited)</i> ¹	56,063	45,710	14,890	20,911	5,892	143,466	(17)
At 31 December 2003 <i>(unaudited)</i> ¹	51,806	38,639	12,948	6,852	6,955	117,200	(24)
At 31 December 2002 <i>(unaudited)</i> ¹	39,398	33,359	10,708	5,188	6,868	95,521	(23)

1 In 2006, Mexico and Panama were reclassified from the North America segment to the Latin America segment. Comparative information has been restated accordingly. See Note 13 on the Financial Statements.

2 2002 to 2004: provisions for bad and doubtful debts.

Financial assets □ net exposure to credit risk*(Audited)*

In respect of certain financial assets, HSBC has legally enforceable rights to offset them with financial liabilities. However, in normal circumstances, there would be no intention of settling net, or of realising the financial assets and settling the financial liabilities simultaneously. Consequently, the financial assets are not offset against the respective financial liabilities for financial reporting purposes. However, the exposure to credit risk relating to the respective financial assets is mitigated as follows.

	At 31 December 2006			At 31 December 2005		
	Carrying amount US\$m	Offset US\$m	Net exposure to credit risk ¹ US\$m	Carrying amount US\$m	Offset US\$m	Net exposure to credit risk ¹ US\$m
Loans and advances held at amortised cost						
Loans and advances to customers	868,133	(68,076)	800,057	751,359	(48,495)	702,864
Loans and advances to banks	185,205	(455)	184,750	125,974	(51)	125,923
	1,053,338	(68,531)	984,807	877,333	(48,546)	828,787
Trading assets						
Treasury and other eligible bills	21,759	(16)	21,743	12,746	□	12,746
Debt securities	155,447	(1,036)	154,411	117,659	□	117,659
Loans and advances to banks	52,006	□	52,006	29,806	(19)	29,787
Loans and advances to customers	71,786	(7,186)	64,600	52,495	(7,411)	45,084
	300,998	(8,238)	292,760	212,706	(7,430)	205,276

Financial assets designated at
fair value

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Treasury and other eligible bills	133	□	133	53	□	53
Debt securities	9,449	□	9,449	5,705	(464)	5,241
Loans and advances to banks	236	□	236	124	□	124
Loans and advances to customers	153	□	153	631	□	631
	9,971	□	9,971	6,513	(464)	6,049
Derivatives	103,702	(62,741)	40,961	73,928	(46,060)	27,868
Financial investments						
Treasury and other similar bills	25,313	(30)	25,283	25,042	□	25,042
Debt securities	171,196	(1)	171,195	149,781	□	149,781
	196,509	(31)	196,478	174,823	□	174,823
Other assets						
Endorsements and acceptances	9,577	(187)	9,390	7,973	(9)	7,964
	1,674,095	(139,728)	1,534,367	1,353,276	(102,509)	1,250,767

1 Excluding the value of any collateral held or other credit enhancements.

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: The Management of Risk (continued)*Credit risk > Exposure > Debt securities / Areas of special interest***Debt securities and other bills by rating agency designation**
(Audited)

The following table presents an analysis by rating agency designation of debt and similar securities, other than loans, based on Standard and Poor's ratings or their equivalent. Debt securities with short-term ratings are reported against the long-term rating of the issuer of the short-term debt securities. If major rating agencies have different ratings for the same debt securities, the securities are reported against the lower rating.

	Treasury bills US\$m	Other eligible bills US\$m	Debt securities US\$m	Total US\$m
At 31 December 2006				
AAA	20,360	282	146,087	166,729
AA □ to AA +	15,478	247	77,578	93,303
A □ to A +	8,146	91	66,408	74,645
Lower than A □	1,208	205	21,240	22,653
Unrated	1,134	□	20,475	21,609
Supporting liabilities under linked insurance and investment contracts and investment contracts with DPF ¹	54	□	4,304	4,358
	46,380	825	336,092	383,297
Of which issued by:				
□ governments	44,941	□	120,369	165,310
□ local authorities	370	□	8,704	9,074
□ corporates	□	68	122,980	123,048
□ other	1,069	757	84,039	85,865
	46,380	825	336,092	383,297
Of which classified as:				
□ trading assets	21,751	8	155,447	177,206
□ financial instruments designated at fair value	133	□	9,449	9,582
□ available-for-sale securities	24,451	817	161,870	187,138
□ held-to-maturity investments	45	□	9,326	9,371
	46,380	825	336,092	383,297
At 31 December 2005²				
AAA	16,798	381	113,429	130,608
AA □ to AA +	3,089	264	62,684	66,037
A □ to A +	11,147	110	46,538	57,795
Lower than A □	3,287	202	23,359	26,848
Unrated	2,563	□	27,135	29,698

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	36,884	957	273,145	310,986
Of which issued by:				
<input type="checkbox"/> governments	19,634	<input type="checkbox"/>	91,279	110,913
<input type="checkbox"/> local authorities	16,646	<input type="checkbox"/>	10,516	27,162
<input type="checkbox"/> corporates	7	84	63,384	63,475
<input type="checkbox"/> other	597	873	107,966	109,436
	36,884	957	273,145	310,986
Of which classified as:				
<input type="checkbox"/> trading assets	12,649	97	117,659	130,405
<input type="checkbox"/> financial instruments designated at fair value	53	<input type="checkbox"/>	5,705	5,758
<input type="checkbox"/> available-for-sale securities	23,974	860	141,699	166,533
<input type="checkbox"/> held-to-maturity investments	208	<input type="checkbox"/>	8,082	8,290
	36,884	957	273,145	310,986

- 1 *For securities supporting liabilities under linked insurance and investment contracts and investment contracts with discretionary participation features (DPF), financial risks are substantially borne by the policyholders.*
- 2 *Securities supporting liabilities under linked insurance and investment contracts and investment contracts with DPF are analysed across the rating agency designations.*

[Back to Contents](#)

Areas of special interest

Mortgage lending products*(Unaudited)*

HSBC underwrites first lien residential mortgages, as well as loans secured by second lien mortgages which are reported within "Other personal lending" in the market sector analysis. In addition to capital or principal repayment mortgages that may be subject to either fixed or variable interest rates, HSBC responds to customer needs by periodically testing and underwriting an increasing range of mortgage products designed to meet the growing demand for flexible house purchase loans.

Interest-only mortgages, including endowment mortgages which are most prevalent in the UK, allow customers to pay only the interest that accrues on the loan, with the principal sum repaid at a later stage. In many cases, customers contribute to an endowment or other investment policy that should, on maturity, provide sufficient capital to repay the principal amount. Alternatively, customers may repay the principal of their loan from the proceeds of the sale of the property on which the loan is secured or from other repayment sources.

"Affordability" mortgages include all products where the customer's monthly payments are maintained at a low or fixed level in early periods using discounted or fixed interest rates, or an interest-only introductory period, before resetting to a higher variable rate or a capital repayment profile in later years.

The US has, in recent years seen a significant change in the structure of borrowing products in the sub-prime mortgage market. In particular, affordability mortgages have grown faster than more

traditional fixed rate mortgages. These have included interest-only, stated income (low documentation), adjustable rate with alternative payment options (known as option ARMs), negatively amortising and layered risk loans, the latter of which includes secondary loans. The growth of affordability mortgages has occurred simultaneously with gradually rising loan-to-value ratios.

Stated income loans have a lesser income documentation requirement during the underwriting process and, accordingly, carry a higher risk. Interest-only loans allow customers to pay only accruing interest for a period of time, and provide customers with repayment flexibility. Adjustable-rate mortgages are loans where the interest rate is periodically adjusted based on an index. Secondary loans which are, for example, drawn down to finance the costs of relocation and property acquisition, are also increasingly common.

As a consequence of US consumer demand for affordability mortgages, this segment of the US loan portfolio experienced rapid growth in 2005, continuing into 2006. HSBC does not offer, and does not anticipate offering, option ARMs or other negative amortisation products.

As with all lending, HSBC underwrites in accordance with criteria that consider the particular terms of the loan and prices affordability products in a manner designed to compensate for the higher risk that exists in these products, notably the increase in payments required at the end of the introductory interest-only period or following the rate reset date.

The following table shows the level of mortgage products in the various portfolios of HSBC Finance and the rest of the HSBC Group.

At 31 December 2006			At 31 December 2005		
HSBC Finance ¹	Other	Total	HSBC Finance ¹	Other	Total

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	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m
Total mortgage lending ²	95,915	192,583	288,498	81,131	176,022	257,153
Interest-only (including endowment) mortgages	□ 33,190	33,190	33,190	□	27,418	27,418
Affordability mortgages, including ARMs	29,536	60,739	90,275	23,971	57,669	81,640
Other	□ 295	295	295	□	388	388
Total interest only and affordability lending	29,536	94,224	123,760	23,971	85,475	109,446
As a percentage of total mortgage lending	30.8%	48.9%	42.9%	29.5%	48.6%	42.6%
Second lien mortgages	19,265	5,093	24,358	14,975	4,889	19,864
As a percentage of total mortgage lending	20.1%	2.6%	8.4%	18.5%	2.8%	7.7%
Negative equity ²	12,343	2,454	14,797	14,160	2,336	16,496
Other loan to value ratios greater than 90 per cent ³	44,450	20,870	65,320	33,302	22,680	55,982
	56,793	23,324	80,117	47,462	25,016	72,478
As a percentage of total mortgage lending	59.2%	12.1%	27.8%	58.5%	14.2%	28.2%

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: The Management of Risk (continued)

Credit risk > Exposure > Areas of special interest / Cross-border distribution

- 1 *HSBC Finance includes lending in Canada and the UK and excludes loans transferred to HSBC USA Inc.*
- 2 *Total mortgage lending includes residential mortgages and second lien mortgage lending included within [Other personal lending].*
- 3 *Loan to value ratios are generally based on values at origination date.*

Mortgage lending in the US*(Unaudited)*

Mortgage lending in the US includes loans and advances to customers with a first lien interest over a property. These balances are secured and are reported within residential mortgages. Loans with only a second lien are reported in other personal lending. The commentary that follows discusses both residential mortgages and second lien loans included within other personal lending.

HSBC continues to monitor a range of trends affecting the US mortgage lending industry. Housing markets in a large part of the US have been affected by a general slowing in the rate of appreciation in property values, or an actual decline in some markets, while the period of time properties remain unsold has increased. In addition, the ability of some borrowers to service their adjustable-rate mortgages ([ARM]s) has been compromised as interest rates have risen, increasing the amounts payable on their loans as prices reset higher under their contracts. The effect of interest rate adjustments on first mortgages are also estimated to have had a direct impact on borrowers' ability to repay any additional second lien mortgages taken out on the same properties. Similarly, as interest-only mortgages leave the interest-only payment period, rising payment obligations are expected to strain the ability of borrowers to make the increased payments. Studies published in the US, and HSBC's own experience, indicate that mortgages originated throughout the industry in 2005 and 2006 are performing worse than loans originated in prior periods.

The effects of these recent trends have been concentrated in the mortgage services business ([mortgage services]), which purchases first and second lien mortgages from a network of over 220 third party lenders. As detailed in the table below, this business has approximately US\$49.5 billion of loans and advances to personal customers, 10.4 per cent of the Group's gross loans and advances to personal customers.

In 2005 and continuing into the first six months of 2006, second lien mortgage loans in mortgage services increased significantly as a percentage of total loans acquired compared with prior periods. During the second quarter of 2006 HSBC began to experience deterioration in the credit performance of mortgages acquired in 2005 by mortgage services in the second lien and portions of the first lien portfolios. The deterioration continued in the third

quarter of 2006 and began to affect second and first lien loans acquired in that year. Further deterioration in the fourth quarter of 2006 was largely in the first lien adjustable-rate and second lien portfolios. HSBC also determined that a significant number of its second lien customers have underlying adjustable-rate first mortgages that face repricing in the near-term which, based on experience, are estimated to adversely affect the probability of repayment on the related second lien mortgage. As numerous interest rate rises have occurred as credit has tightened and there has been either a slowdown in the rate of appreciation of properties or a decline in their value, it is estimated that the probability of default on adjustable-rate first mortgages subject to repricing, and on any second lien mortgage loans that are subordinate to adjustable-rate first liens, is greater than has been experienced in the past. As a result, loan impairment charges relating to the mortgage services portfolio have increased significantly.

Accordingly, while overall credit performance, as measured by delinquency and write-off rates, has performed broadly in line with industry trends across other parts of the US mortgage portfolio, higher delinquency and losses have been reported in mortgage services, largely in the aforementioned loans originated in 2005 and 2006. A number of steps have been taken to mitigate risk in the affected parts of the portfolio. These include enhanced segmentation and analytics to identify the higher risk portions of the portfolio, and increased collections capacity. HSBC is restructuring or modifying loans in accordance with defined policies if it believes that customers will continue to pay the restructured or modified loan. Also, customers who have adjustable-rate mortgage loans nearing the first reset, and who are expected to be the most affected by a rate adjustment, are being contacted in order to assess their ability to make the higher payment and, as appropriate, refinance or modify their loans. Furthermore, HSBC has slowed growth in this portion of the portfolio by implementing repricing initiatives in selected segments of the originated loans and tightening underwriting criteria, especially for second lien, stated income (low documentation) and other higher risk segments. These actions, combined with normal attrition, resulted in a net reduction in loans and advances in mortgage services during the second half of 2006. It is expected that this portfolio will remain under pressure as the loans originated in 2005 and 2006 season. It is also expected that this portfolio will run off faster than in

[Back to Contents](#)

the past as originations in it will be limited in 2007 and beyond. Accordingly, the increasing trend in overall delinquency and write-offs in mortgage services is expected to continue.

US mortgage loan balances

(Unaudited)

The following table summarises mortgage balance information for the mortgage services and consumer lending businesses within Personal Financial Services in the US. Mortgages include first lien residential mortgages, and second lien mortgage lending which is reported within "Other personal lending" in the market sector analysis.

At 31 December 2006, the outstanding balance of interest-only loans in the US mortgage services business was US\$6.3 billion, or 1.3 per cent of the Group's gross loans and advances to personal customers, a rise of 22 per cent compared with US\$5.2 billion, or 1.2 per cent of loans in 2005.

The outstanding balance of adjustable rate mortgages in the US mortgage services business at 31 December 2006 was US\$20.8 billion, 4.4 per cent of the Group's gross loans and advances to personal customers, a rise of 9 per cent compared with the end of 2005.

In 2007, approximately US\$13.2 billion of adjustable rate mortgage loans will reach their first interest rate reset, of which US\$2.5 billion relate to HSBC USA Inc and US\$10.7 billion to HSBC Finance, within which US\$9.9 billion is mortgage services, the remainder consumer lending. In 2008, a further US\$8.7 billion of adjustable-rate mortgage loans will reset for the first time, of which US\$3.6 billion relate to HSBC USA Inc and US\$5.1 billion to HSBC Finance, within which US\$3.8 billion is mortgage services, the remainder consumer lending. Adjustable rate mortgages in HSBC USA Inc. are largely prime balances.

The balance of stated income mortgages was approximately US\$14.4 billion at the end of 2006, or 3 per cent of Group's gross loans and advances to personal customers. At the end of 2005, the outstanding balance was US\$9.6 billion, or 2.3 per cent of loans. Of these amounts, US\$11.8 billion and US\$7.3 billion at the end of 2006 and 2005, respectively, relate to HSBC Finance mortgage services. There were no stated income mortgages in consumer lending in either period. The remainder of the stated income balances are held by HSBC USA Inc.

(Unaudited)

	Year ended 31 December 2006			Year ended 31 December 2005		
	Mortgage services US\$m	Consumer lending US\$m	Other mortgage lending US\$m	Mortgage services US\$m	Consumer lending US\$m	Other mortgage lending US\$m
Fixed rate	22,358	42,371	7,655	20,088	36,187	6,507
Adjustable-rate	27,114	3,528	24,817	24,211	1,796	29,110
Total	49,472	45,899	32,472	44,299	37,983	35,617
First lien	39,404	39,399	28,780	36,278	33,242	32,286
Second lien	10,068	6,500	3,692	8,021	4,741	3,331
Total	49,472	45,899	32,472	44,299	37,983	35,617
Adjustable-rate	20,795	3,528	16,251	19,037	1,796	19,473
Interest-only	6,319		8,566	5,174		9,637

Total adjustable-rate	27,114	3,528	24,817	24,211	1,796	29,110
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Country distribution of outstandings and cross-border exposures
(Unaudited)

HSBC controls the risk associated with cross-border lending, essentially that foreign currency will not be made available to local residents to make payments, through a centralised structure of internal country limits which are determined by taking into account relevant economic and political factors. Exposures to individual countries and cross-border exposure in aggregate are kept under continual review.

The following table summarises the aggregate of in-country foreign currency and cross-border outstandings by type of borrower to countries which individually represent in excess of 1 per cent of HSBC's total assets. The classification is based on the country of residence of the borrower but also recognises the transfer of country risk in respect of third party guarantees, eligible collateral held and residence of the head office when the borrower is a branch. In accordance with the Bank of England Country Exposure Report (Form CE) guidelines,

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: The Management of Risk (continued)*Credit risk > Exposure / Credit quality > Loans and advances*

outstandings comprise loans and advances (excluding settlement accounts), amounts receivable under finance leases, acceptances, commercial bills,

certificates of deposit, and debt and equity securities (net of short positions), and exclude accrued interest and intra-HSBC exposures.

In-country foreign currency and cross-border outstandings*(Unaudited)*

	Banks US\$bn	Government and official institutions US\$bn	Other US\$bn	Total US\$bn
At 31 December 2006				
UK	24.8	□	33.5	58.3
Germany	23.7	18.9	2.0	44.6
US	9.5	12.7	16.2	38.4
France	22.1	2.4	6.1	30.6
The Netherlands	14.4	2.1	3.9	20.4
Italy	4.7	12.5	1.4	18.6
At 31 December 2005				
UK	19.6	3.7	16.2	39.5
US	10.2	11.1	17.1	38.4
Germany	21.6	12.7	3.3	37.6
France	11.5	4.7	5.4	21.6
The Netherlands	11.9	2.6	4.4	18.9
Italy	4.4	10.6	3.5	18.5
At 31 December 2004				
UK	19.7	3.8	24.5	48.0
US	9.2	13.3	14.0	36.5
Germany	17.8	10.4	4.0	32.2
France	11.1	3.7	4.6	19.4
Italy	5.7	9.7	2.1	17.5
The Netherlands	9.1	2.2	4.2	15.5
Hong Kong	1.6	1.1	10.3	13.0

At 31 December 2006, HSBC had in-country foreign currency and cross-border outstandings to counterparties in Australia and Hong Kong of between 0.75 per cent and 1 per cent of total assets. The aggregate in-country foreign currency and cross-border outstandings were Australia: US\$17.5 billion; Hong Kong: US\$15.5 billion.

At 31 December 2005, HSBC had in-country foreign currency and cross-border outstandings to counterparties in Hong Kong, Australia and Canada of between 0.75 per cent and 1 per cent of total assets. The aggregate

in-country foreign currency and cross-border outstandings were Hong Kong: US\$14.6 billion; Australia: US\$12.5 billion; Canada: US\$11.7 billion.

At 31 December 2004, HSBC had in-country foreign currency and cross-border outstandings to counterparties in Australia and Canada of between 0.75 per cent and 1 per cent of total assets. The aggregate in-country foreign currency and cross-border outstandings were Australia: US\$12.7 billion; Canada: US\$11.8 billion.

Credit quality

The following tables reflect broadly stable credit quality across the majority of the Group's businesses. However, loans and advances in grades 1-3 (satisfactory risk) declined to 91.7 per cent (2005: 96.4 per cent) of loans and advances to customers neither past due nor impaired. This was mainly due to the transfer of the US mortgage services book of US\$44.5 billion to grades 4 and 5 to reflect increased scrutiny of this portfolio for the reasons explained on page 189. Excluding this realignment, satisfactory risk across the remainder of the Group showed a marginally improving trend.

The deterioration in quality in US first lien and second lien mortgages (and, to a lesser extent, UK personal unsecured portfolios) also reflected in an increase in the proportion of customer loans and advances which were past due but not impaired to 1.28 per cent (2005: 1.17 per cent).

Credit quality of loans and advances to banks was stable.

[Back to Contents](#)

Loans and advances

Distribution of loans and advances by credit quality*(Audited)*

	At 31 December 2006		At 31 December 2005	
	Loans and advances to customers US\$m	Loans and advances to banks US\$m	Loans and advances to customers US\$m	Loans and advances to banks US\$m
Loans and advances:				
□ neither past due nor impaired	856,681	185,125	731,116	125,930
□ past due but not impaired	11,245	72	8,797	22
□ impaired	13,785	15	11,446	22
	881,711	185,212	751,359	125,974

Distribution of loans and advances neither past due nor impaired*(Audited)*

The credit quality of the portfolio of loans and advances that were neither past due nor impaired can be assessed by reference to the Group's standard

credit grading system, as described on page 173. The following information is based on that system:

	At 31 December 2006		At 31 December 2005	
	Loans and advances to customers US\$m	Loans and advances to banks US\$m	Loans and advances to customers US\$m	Loans and advances to banks US\$m
Grades:				
1 to 3 □ satisfactory risk	785,946	184,059	705,036	125,324
4 □ watch list and special mention	62,557	1,040	19,950	555
5 □ sub-standard but not impaired	8,178	26	6,130	51
	856,681	185,125	731,116	125,930

This analysis excludes loans and advances graded 1-5 that are contractually past due.

The HSBC Finance mortgage services portfolio of US\$44.5 billion included in the above table is reported in grades 4 and 5.

Loans and advances which were past due but not impaired*(Audited)*

Examples of exposures designated past due but not considered impaired include loans fully secured by cash collateral, residential mortgages in arrears more than 90 days, but where the value of collateral is sufficient to repay both the principal debt and all

potential interest for at least one year, and short-term trade facilities past due more than 90 days for technical reasons such as delays in documentation, but where there is no concern over the creditworthiness of the counterparty.

	At 31 December 2006		At 31 December 2005	
	Loans and advances to customers	Loans and advances to banks	Loans and advances to customers	Loans and advances to banks
	US\$m	US\$m	US\$m	US\$m
Past due up to 29 days	6,625	72	4,837	22
Past due 30 □ 59 days	1,875	□	1,743	□
Past due 60 □ 89 days	822	□	583	□
	9,322	72	7,163	22
Past due 90 □ 179 days	1,764	□	1,368	□
Past due over 180 days but less than 1 year	159	□	266	□
	11,245	72	8,797	22

This ageing analysis includes past due loans and advances that have collective impairment allowances set aside to cover credit losses on loans which are in the early stages of arrears.

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: The Management of Risk (continued)*Credit risk > Credit quality > Loans and advances > 2006***Impaired loans and advances***(Audited)*

	At 31 December	
	2006 US\$m	2005 US\$m
Total impaired loans and advances to:		
□ banks	15	22
□ customers	13,785	11,446
	13,800	11,468
Total allowances cover as a percentage of impaired loans and advances	98.4%	99.1%

Impaired customer loans and impairment allowances by geographical region*(Audited)*

	At 31 December 2006		At 31 December 2005 <i>(restated¹)</i>	
	Impaired loans US\$m	Impairment allowances US\$m	Impaired loans US\$m	Impairment allowances US\$m
Europe	5,847	3,676	5,068	3,491
Hong Kong	454	365	506	398
Rest of Asia-Pacific	1,184	901	936	836
North America	4,822	7,247	3,710	5,349
Latin America	1,478	1,389	1,226	1,283
	13,785	13,578	11,446	11,357

¹ In 2006, Mexico and Panama were reclassified from the North America segment to the Latin America segment. Comparative information has been restated accordingly. See Note 13 on the Financial Statements.

The total gross amount of impaired loans and advances to customers as at 31 December 2006 was US\$13,785 million (2005: US\$11,446 million), of which US\$5,833 million (2005: US\$4,960 million) related to individually impaired loans and advances

and US\$7,952 million (2005: US\$6,486 million) related to portfolios of homogeneous loans and advances. The following table presents an analysis of individually impaired loans by industry sector and by geographical region:

Individually impaired loans and advances to customers*(Audited)*

	Europe US\$m	Hong Kong US\$m	Rest of Asia- Pacific US\$m	North America US\$m	Latin America US\$m	Gross impaired loans and advances to customers US\$m	% of total gross impaired loans ¹ %
At 31 December 2006							
Individually impaired loans and advances to customers:							
□ personal	975	231	118	173	1	1,498	25.7
□ commercial and corporate	3,056	176	531	248	324	4,335	74.3
	<u>4,031</u>	<u>407</u>	<u>649</u>	<u>421</u>	<u>325</u>	<u>5,833</u>	<u>100.0</u>
At 31 December 2005							
<i>(restated²).</i>							
Individually impaired loans and advances to customers:							
□ personal	655	256	119	□	5	1,035	20.9
□ commercial and corporate	2,562	198	629	330	206	3,925	79.1
	<u>3,217</u>	<u>454</u>	<u>748</u>	<u>330</u>	<u>211</u>	<u>4,960</u>	<u>100.0</u>

1 *Gross impaired loans by industry sector as a percentage of total gross impaired loans.*

2 *In 2006, Mexico and Panama were reclassified from the North America segment to the Latin America segment. Comparative information has been restated accordingly. See Note 13 on the Financial Statements.*

[Back to Contents](#)

Year ended 31 December 2006 compared with year ended 31 December 2005
(Unaudited)

Total impaired loans to customers were US\$13,785 million at 31 December 2006, an increase of 20 per cent since the end of 2005. At constant currency the growth was 14 per cent and, at 31 December 2006, impaired loans as a percentage of gross customer loans and advances were 1.56 per cent (2005: 1.52 per cent). The US represented 9 percentage points of overall growth and 33 per cent of total impaired customer loans at 31 December 2006.

The commentary that follows is based on constant exchange rates.

In **Europe**, impaired loans rose by 4 per cent to US\$5,847 million in 2006. In the UK, impaired loans grew by 11 per cent over the same period. The UK market remained challenging, with pressure on consumers through high levels of personal indebtedness, compounded by interest rate rises. These effects were to an extent masked by the growing prevalence of personal bankruptcies and IVAs, at the completion of which any unpaid balances are written off. UK commercial and corporate lending remained broadly stable. In France, impaired loans fell mainly as a result of more active portfolio management, including the sale of a portfolio of substantially impaired debt and, in Turkey, higher impaired balances were broadly in line with growth in customer advances; the credit environment in these countries was relatively stable.

Impaired loans in **Hong Kong** were 10 per cent lower at US\$454 million at 31 December 2006. HSBC responded to moderate volatility in its loan portfolio by launching a number of initiatives to strengthen credit management and risk monitoring procedures, in order to improve the credit quality of its portfolio. As a result, the number of newly impaired loans fell and an increased number of loans were written off.

In the **Rest of Asia-Pacific**, impaired loans increased by 23 per cent to US\$1,184 million. In Taiwan, delinquency problems emerged in the middle of 2005, centred on a relatively small number of highly leveraged consumers. This prompted a range of regulatory changes aimed at avoiding a financial crisis, the most significant being the introduction of a government debt negotiation mechanism by which banks were instructed to make available deferred repayment terms at discounted rates. The consequence of this was to widen considerably the group of debtors seeking relief and increase substantially HSBC's impaired loans to

some US\$340 million. In the Middle East, the 8 per cent rise in impaired loans reflected lending growth. Impaired loans declined in most other countries, reflecting buoyant regional economies.

In **North America** there was a rise of 30 per cent in impaired loans, to US\$4,822 million at 31 December 2006. Growth was substantially driven by credit deterioration in second lien, some portions of first lien and adjustable-rate mortgages in the US mortgage services book, as detailed on page 189.

This was partly offset by the non-recurrence of significant loan impairment allowances which were raised in 2005 as a result of hurricane Katrina and increased levels of bankruptcy filings in the fourth quarter of the year. As a consequence of this latter factor, HSBC experienced bankruptcies significantly below long-term trends in the first half of 2006. Continuing assessments of the financial impact of hurricane Katrina on HSBC Finance's customers living in the Katrina Federal Emergency Management Agency designated Individual Assistance disaster areas resulted in a downwards revision of the estimate of credit loss exposure in the first half of 2006.

In contrast to the accelerated credit weakness witnessed in the mortgage services business, the trend of credit delinquency across the majority of the other portfolios, including mortgage balances originated through the branch-based consumer lending business, rose modestly, driven by growing portfolio maturity and a higher mix of credit card receivables following the Metris acquisition.

In Canada, impaired loans increased as a small number of commercial customers in the manufacturing sector were adversely affected by the stronger Canadian dollar.

In **Latin America**, impaired loans increased by 14 per cent to US\$1,478 million, partly due to acquisitions in 2006 and partly to a higher amount of personal lending. Growth was mainly in Mexico and Brazil. In Mexico,

impaired loans rose through strong growth in lending to personal and commercial customers, particularly the small and middle market sectors. In Brazil, impaired loans rose by 6 per cent, reflecting lending growth and some continuing credit stress, in part mitigated through tightened underwriting criteria introduced during 2005 and 2006.

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: The Management of Risk (continued)*Credit risk > Credit quality / Impairment allowances and charges***Interest forgone on impaired loans***(Audited)*

Interest income that would have been recognised under the original terms of impaired and restructured loans amounted to approximately US\$104 million in 2006, compared with US\$275 million in 2005 and US\$280 million in 2004. Interest income from such loans of approximately US\$276 million was recorded in 2006, compared with US\$120 million in 2005.

Renegotiated loans*(Audited)*

Restructuring activity is designed to manage customer relationships, maximise collection opportunities and, if possible, avoid foreclosure or repossession. Such activities include extended payment arrangements, approved external debt management plans, deferring foreclosure, modification, loan rewrites and/or deferral of payments pending a change in circumstances. Following restructuring, an overdue consumer account is normally reset from delinquent to current status. Restructuring policies and practices are based on indicators or criteria which, in the judgement of local management, indicate that repayment will probably continue. These policies are required to be kept under continual review and their application varies according to the nature of the market, the product, and the availability of empirically based data. When empirical evidence indicates an increased propensity to default on restructured accounts, the use of roll rate methodology ensures this factor is taken into account when calculating impairment allowances.

Renegotiated loans that would otherwise be past due or impaired totalled US\$20.7 billion at 31 December 2006 (2005: US\$18.1 billion).

Restructuring is most commonly applied to consumer finance portfolios. The largest concentration is in the US, and amounts to US\$16.7 billion (2005: US\$14.2 billion) or 81 per cent (2005: 79 per cent) of the total renegotiated loans. The increase was substantially driven by credit deterioration in second lien, some portions of first lien, and adjustable-rate mortgages in the US mortgage services book as detailed on page 189. The majority of restructured amounts arise from secured lending.

Collateral and other credit enhancements obtained*(Audited)*

HSBC obtained assets by taking possession of collateral held as security, or calling upon other credit enhancements, as follows:

*(Audited)***Carrying amount
obtained in:**

	2006 US\$m	2005 US\$m
Nature of assets		
Residential property	1,716	1,171
Commercial and industrial property	6	26
Other	215	138

<u>1,937</u>	<u>1,335</u>
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Repossessed properties are made available for sale in an orderly fashion, with the proceeds used to reduce or repay the outstanding indebtedness. Where excess funds are available after the debt has been repaid, they are available either for other secured lenders with lower priority or are returned to the customer. HSBC does not generally occupy repossessed properties for its business use. The majority of repossessed properties arose in HSBC Finance.

[Back to Contents](#)**Impairment allowances and charges****Movement in allowance accounts for total loans and advances***(Audited)*

	Individually assessed US\$m	Collectively assessed US\$m	Total US\$m
At 1 January 2006	2,679	8,687	11,366
Amounts written off	(1,023)	(8,450)	(9,473)
Recoveries of loans and advances written off in previous years	128	651	779
Charge to income statement	458	10,089	10,547
Exchange and other movements	330	36	366
At 31 December 2006	2,572	11,013	13,585
At 1 January 2005	3,728	8,906	12,634
Amounts written off	(1,102)	(7,941)	(9,043)
Recoveries of loans and advances written off in previous years	199	295	494
Charge to income statement	518	7,342	7,860
Exchange and other movements	(664)	85	(579)
At 31 December 2005	2,679	8,687	11,366

Impairment allowances as a percentage of loans and advances to customers*(Unaudited)*

	At 31 December	
	2006	2005
	%	%
Total impairment allowances to gross lending¹		
Individually assessed impairment allowances	0.30	0.36
Collectively assessed impairment allowances	1.28	1.18
	1.58	1.54

¹ Net of reverse repo transactions, settlement accounts and stock borrowings.

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: The Management of Risk (continued)*Credit risk > Impairment allowances and charges***Movement in impairment allowances by industry segment and by geographical region**

The following tables show details of the movements in HSBC's impairment allowances by location of lending office for each of the past five years.

A discussion of the material movements in the loan impairment charges by region follows these tables.

(Audited)

	2006					
	Europe US\$m	Hong Kong US\$m	Rest of Asia- Pacific US\$m	North America US\$m	Latin America US\$m	Total US\$m
Impairment allowances at 1 January <i>(restated³)</i> .	3,499	398	837	5,349	1,283	11,366
Amounts written off						
Commercial, industrial and international trade	(454)	(56)	(79)	(97)	(96)	(782)
Real estate	(70)	(6)	(8)	(21)	(6)	(111)
Non-bank financial institutions	(20)	(7)	(11)	(1)	□	(39)
Other commercial	(116)	(3)	(7)	(31)	(103)	(260)
Residential mortgages	(2)	(3)	(7)	(595)	(21)	(628)
Other personal	(2,044)	(140)	(454)	(4,188)	(827)	(7,653)
	(2,706)	(215)	(566)	(4,933)	(1,053)	(9,473)
Recoveries of amounts written off in previous years						
Commercial, industrial and international trade	25	5	11	20	27	88
Real estate	15	□	3	3	□	21
Non-bank financial institutions	1	□	□	10	□	11
Other commercial	24	□	2	9	19	54
Residential mortgages	3	8	1	7	□	19
Other personal	357	26	77	36	90	586
	425	39	94	85	136	779
Charge to income statement ¹						
Banks	□	□	(1)	□	(2)	(3)
Commercial, industrial and international trade	246	40	(14)	107	124	503
Real estate	41	6	3	19	6	75

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Non-bank financial institutions	(7)	□	(1)	(4)	6	(6)
Governments	(13)	□	□	(1)	(23)	(37)
Other commercial	23	(2)	(19)	18	66	86
Residential mortgages	24	4	□	1,039	29	1,096
Other personal	1,826	109	544	5,620	734	8,833
	<u>2,140</u>	<u>157</u>	<u>512</u>	<u>6,798</u>	<u>940</u>	<u>10,547</u>
Foreign exchange and other movements	325	(14)	24	(52)	83	366
Impairment allowances at 31 December	<u>3,683</u>	<u>365</u>	<u>901</u>	<u>7,247</u>	<u>1,389</u>	<u>13,585</u>
Impairment allowances against banks:						
□ individually assessed	7	□	□	□	□	7
Impairment allowances against customers:						
□ individually assessed	1,725	131	362	109	238	2,565
□ collectively assessed	1,951	234	539	7,138	1,151	11,013
Impairment allowances at 31 December	<u>3,683</u>	<u>365</u>	<u>901</u>	<u>7,247</u>	<u>1,389</u>	<u>13,585</u>
	%	%	%	%	%	%
Impairment allowances against customers as a percentage of loans and advances to customers:						
□ individually assessed	0.44	0.15	0.46	0.04	0.64	0.29
□ collectively assessed	0.49	0.28	0.69	2.50	3.10	1.25
At 31 December	<u>0.93</u>	<u>0.43</u>	<u>1.15</u>	<u>2.54</u>	<u>3.74</u>	<u>1.54</u>

1 See table below □Net impairment charge to income statement by geographical region□.

2 Collectively assessed impairment allowances are allocated to geographical segments based on the location of the office booking the allowance. Consequently, the collectively assessed impairment allowances booked in Hong Kong may cover assets booked in branches located outside Hong Kong, principally in the Rest of Asia-Pacific, as well as those booked in Hong Kong.

3 In 2006, Mexico and Panama were reclassified from the North America segment to the Latin America segment. Comparative information has been restated accordingly. See Note 13 on the Financial Statements.

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[Back to Contents](#)

(Audited)

2005 (restated³)

	Europe US\$m	Hong Kong US\$m	Rest of Asia- Pacific US\$m	North America US\$m	Latin America US\$m	Total US\$m
Impairment allowances at 1 January	4,851	504	960	5,231	1,088	12,634
Amounts written off						
Commercial, industrial and international trade	(345)	(157)	(79)	(81)	(11)	(673)
Real estate	(67)	(23)	(11)	(14)	(2)	(117)
Non-bank financial institutions	(3)	□	□	(10)	□	(13)
Other commercial	(108)	□	(6)	(14)	(66)	(194)
Residential mortgages	(14)	(2)	(6)	(456)	(30)	(508)
Other personal	(2,267)	(112)	(227)	(4,338)	(594)	(7,538)
	(2,804)	(294)	(329)	(4,913)	(703)	(9,043)
Recoveries of amounts written off in previous years						
Commercial, industrial and international trade	10	4	17	37	8	76
Real estate	5	□	1	2	1	9
Other commercial	6	1	2	38	42	89
Residential mortgages	1	9	1	□	7	18
Other personal	62	31	61	70	78	302
	84	45	82	147	136	494
Net charge/(release) to income statement ¹						
Banks	(5)	□	(2)	□	□	(7)
Commercial, industrial and international trade	354	199	(72)	32	75	588
Real estate	59	□	1	(6)	2	56
Non-bank financial institutions	(14)	(1)	□	9	□	(6)
Governments	4	□	□	2	□	6
Other commercial	(21)	(32)	(1)	(18)	46	(26)
Residential mortgages	5	(25)	7	592	26	605
Other personal	1,602	5	203	4,308	526	6,644
	1,984	146	136	4,919	675	7,860
Foreign exchange and other movements	(616)	(3)	(12)	(35)	87	(579)
Impairment allowances at 31 December	3,499	398	837	5,349	1,283	11,366
Impairment allowances against banks:						
□ individually assessed	8	□	1	□	□	9
Impairment allowances against customers:						
□ individually assessed	1,575	173	500	221	214	2,683
□ collectively assessed	1,916	225	336	5,128	1,069	8,674

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Impairment allowances at 31 December	3,499	398	837	5,349	1,283	11,366
	%	%	%	%	%	%
Impairment allowances against customers as a percentage of loans and advances to customers:						
□ individually assessed	0.50	0.21	0.71	0.09	0.93	0.36
□ collectively assessed	0.61	0.27	0.47	1.99	4.65	1.16
At 31 December	1.11	0.48	1.18	2.08	5.58	1.52

- 1 See table below [Net impairment charge to income statement by geographical region].
- 2 Collectively assessed impairment allowances are allocated to geographical segments based on the location of the office booking the allowance. Consequently, the collectively assessed impairment allowances booked in Hong Kong may cover assets booked in branches located outside Hong Kong, principally in the Rest of Asia-Pacific, as well as those booked in Hong Kong.
- 3 In 2006, Mexico and Panama were reclassified from the North America segment to the Latin America segment. Comparative information has been restated accordingly. See Note 13 on the Financial Statements.

[Back to Contents](#)

HSBC HOLDINGS PLC

Report of the Directors: The Management of Risk (continued)*Credit risk > Impairment allowances and charges***Movement in provisions by industry segment and by geographical region***(Unaudited)*

	2004 (restated ³)					
	Europe US\$m	Hong Kong US\$m	Rest of Asia- Pacific US\$m	North America US\$m	Latin America US\$m	Total US\$m
Provisions at 1 January	4,435	1,055	1,181	5,665	1,379	13,715
IFRSs transition adjustment at 1 January	(2)	(34)	(21)	□	(1)	(58)
Amounts written off						
Commercial, industrial and international trade	(298)	(35)	(164)	(61)	(65)	(623)
Real estate	(30)	(55)	(17)	(3)	(1)	(106)
Non-bank financial institutions	(14)	(2)	(1)	(3)		(20)
Other commercial	(209)	(33)	(42)	(29)	(185)	(498)
Residential mortgages	(10)	(52)	(8)	(463)	(28)	(561)
Other personal	(770)	(125)	(171)	(5,566)	(404)	(7,036)
	<u>(1,331)</u>	<u>(302)</u>	<u>(403)</u>	<u>(6,125)</u>	<u>(683)</u>	<u>(8,844)</u>
Recoveries of amounts written off in previous years						
Commercial, industrial and international trade	27	10	4	38	39	118
Real estate	3	□	10	4	□	17
Non-bank financial institutions	3	□	□	□	□	3
Other commercial	5	3	14	18	45	85
Residential mortgages	1	12	1	8	9	31
Other personal	97	22	41	436	63	659
	<u>136</u>	<u>47</u>	<u>70</u>	<u>504</u>	<u>156</u>	<u>913</u>
Net charge to profit and loss account ¹						
Banks	(7)	□	(1)	□	(2)	(10)
Commercial, industrial and international trade	180	(56)	52	(9)	12	179
Real estate	21	(15)	(28)	(1)	1	(22)
Non-bank financial institutions	18	(3)	(1)	1	□	15
Governments	□	□	□	1	□	1
Other commercial	(65)	(29)	(18)	(21)	(35)	(168)
Residential mortgages	3	(14)	4	494	(5)	482
Other personal	1,035	120	142	4,616	303	6,216
General provisions	(162)	(223)	(48)	(63)	(2)	(498)
	<u>1,023</u>	<u>(220)</u>	<u>102</u>	<u>5,018</u>	<u>272</u>	<u>6,195</u>

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Foreign exchange and other movements	551	(24)	14	150	(53)	638
Provisions at 31 December	4,812	522	943	5,212	1,070	12,559
Provisions against banks:						
□ specific provisions	14	□	3	□	□	17
Provisions against customers:						
□ specific provisions	4,036	320	785	4,106	770	10,017
□ general provisions ²	762	202	155	1,106	300	2,525
Provisions at 31 December	4,812	522	943	5,212	1,070	12,559
	%	%	%	%	%	%
Provisions against customers as a percentage of loans and advances to customers:						
□ specific provisions	1.43	0.40	1.27	1.67	4.58	1.46
□ general provisions	0.27	0.25	0.25	0.45	1.79	0.37
At 31 December	1.70	0.65	1.52	2.12	6.37	1.83

- 1 See table below □Net charge to the profit and loss account for bad and doubtful debts by geographical region□.
- 2 General provisions are allocated to geographical segments based on the location of the office booking the provision. Consequently, the general provision booked in Hong Kong may cover assets booked in branches located outside Hong Kong, principally in the Rest of Asia-Pacific, as well as those booked in Hong Kong.
- 3 In 2006, Mexico and Panama were reclassified from the North America segment to the Latin America segment. Comparative information has been restated accordingly. See Note 13 on the Financial Statements.

[Back to Contents](#)

(Unaudited)

2003 (restated⁴)

	Europe US\$m	Hong Kong US\$m	Rest of Asia- Pacific US\$m	North America US\$m	Latin America US\$m	Total US\$m
Provisions at 1 January	3,668	1,143	1,496	642	2,191	9,140
Amounts written off						