

HSBC HOLDINGS PLC
Form 20-F
March 10, 2009

As filed with the Securities and Exchange Commission on March 10, 2009.

**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, 2008

or

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

or

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

Date of event requiring this shell company report
For the transition period from N/A to N/A

Commission file number: 1-14930

HSBC Holdings plc

(Exact name of Registrant as specified in its charter)

N/A

United Kingdom

(Translation of Registrant's name into English)

(Jurisdiction of incorporation or organisation)

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London E14 5HQ
United Kingdom

(Address of principal executive offices)

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

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

Title of each class

Name of each exchange on which registered

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Ordinary Shares, nominal value US\$0.50 each.

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

American Depository 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

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

New York Stock Exchange
 New York Stock Exchange
 New York Stock Exchange
 New York Stock Exchange
 New York Stock Exchange
 New York Stock Exchange

5.25% Subordinated Notes 2012

6.5% Subordinated Notes 2036

6.5% Subordinated Notes 2037

6.8% Subordinated Notes Due 2038

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

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

12,105,265,082

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

Yes

No

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

Yes

No.

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

Yes

No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

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

U.S. GAAP

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

Other

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

Item 17

Item 18

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

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Yes

No

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

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HSBC HOLDINGS PLC

Annual Report and Accounts 2008

Headquartered in London, HSBC is one of the largest banking and financial services organisations in the world. Its international network comprises some 10,000 properties in 86 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 over 210,000 shareholders in 120 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 100 million customers through four customer groups and global businesses: Personal Financial Services (including consumer finance); Commercial Banking; Global Banking and Markets; and Private Banking.

Certain defined terms

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

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

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1 Detailed contents are provided on the referenced pages.

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HSBC HOLDINGS PLC

Financial Highlights

Highlights / Ratios

For the year

- Total operating income up by 1 per cent to US\$88,571 million (2007: US\$87,601 million).
- Net operating income before loan impairment charges up by 3 per cent to US\$81,682 million (2007: US\$78,993 million).
- Group pre-tax profit down by 62 per cent to US\$9,307 million (2007: US\$24,212 million).
- Profit attributable to shareholders of the parent company down by 70 per cent to US\$5,728 million (2007: US\$19,133 million).
- Return on average shareholders' equity of 4.7 per cent (2007: 15.9 per cent).
- Earnings per ordinary share down by 72 per cent to US\$0.47 (2007: US\$1.65).

At the year-end¹

- Total equity down by 26 per cent to US\$100,229 million (2007: US\$135,416 million).
- Customer accounts and deposits by banks up by 1 per cent to US\$1,245,411 million (2007: US\$1,228,321 million).
- Risk-weighted assets up by 2 per cent to US\$1,147,974 million (2007: US\$1,123,782 million).

Dividends and capital position¹

- Total dividends declared in respect of 2008 of US\$0.64 per share, a decrease of 28.9 per cent over dividends for 2007; fourth interim dividend for 2008 of US\$0.10 per share, a decrease of 74.4 per cent.
- Tier 1 ratio of 8.3 per cent and total capital ratio of 11.4 per cent.

Dividends per share²
(US dollars)

Return on average invested capital
(per cent)

Earnings per share
(US dollars)

Cost efficiency ratio
(per cent)

For footnotes, see page 5.

[Back to Contents](#)**Capital and performance ratios**

	2008	2007
	%	%
Capital ratios¹		
Tier 1 ratio	8.3	9.3
Total capital ratio	11.4	13.6

Performance ratios

Return on average invested capital ³	4.0	15.3
Return on average total shareholders' equity ⁴	4.7	15.9
Post-tax return on average total assets	0.26	0.97
Post-tax return on average risk-weighted assets	0.55	1.95

Credit coverage ratios

Loan impairment charges as a percentage of total operating income	27.24	19.61
Loan impairment charges as a percentage of average gross customer advances	2.46	1.97
Total impairment allowances outstanding as a percentage of impaired loans at the year-end	94.3	98.1

Efficiency and revenue mix ratios

Cost efficiency ratio ⁵	60.1	49.4
As a percentage of total operating income:		
□ net interest income	48.1	43.1
□ net fee income	22.6	25.1
□ net trading income	7.4	11.2

Financial ratios

Loans and advances to customers as a percentage of customer accounts	83.6	89.5
Average total shareholders' equity to average total assets	4.87	5.69

Share information at the year-end

	2008	2007
US\$0.50 ordinary shares in issue (million)	12,105	11,829
Market capitalisation (billion)	US\$114	US\$198
Closing market price per ordinary share:		
□ London	£6.62	£8.42
□ Hong Kong	HK\$73.70	HK\$131.70
Closing market price per American Depositary Share ⁷	US\$48.67	US\$83.71

	Over 1 year	Over 3 years	Over 5 years
HSBC total shareholder return to 31 December 2008 ⁸	84.5	84.5	98.5
Benchmarks:			
□ FTSE 100	71.7	88.1	118.3
□ MSCI World ⁹	81.8	93.6	123.7
□ MSCI Banks ¹	63.0	60.8	82.7

For footnotes, see page 5.

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HSBC HOLDINGS PLC

Financial Highlights (continued)

5-year comparison

Five-year comparison

	2008 US\$m	2007 US\$m	2006 US\$m	2005 US\$m	2004 ¹² US\$m
For the year					
Net interest income	42,563	37,795	34,486	31,334	31,099
Other operating income	46,008	49,806	35,584	30,370	24,889
Loan impairment charges and other credit risk provisions	(24,937)	(17,242)	(10,573)	(7,801)	(6,191)
Total operating expenses	(49,099)	(39,042)	(33,553)	(29,514)	(26,487)
Profit before tax	9,307	24,212	22,086	20,966	18,943
Profit attributable to shareholders of the parent company	5,728	19,133	15,789	15,081	12,918
Dividends ²	11,301	10,241	8,769	7,750	6,932

At the year-end

Called up share capital	6,053	5,915	5,786	5,667	5,587
Total shareholders' equity	93,591	128,160	108,352	92,432	85,522
Capital resources ^{1,13}	131,460	152,640	127,074	105,449	90,780
Customer accounts	1,115,327	1,096,140	896,834	739,419	693,072
Undated subordinated loan capital	2,843	2,922	3,219	3,474	3,686
Preferred securities and dated subordinated loan capital ¹⁴	50,307	49,472	42,642	35,856	32,914
Loans and advances to customers ¹⁵	932,868	981,548	868,133	740,002	672,891
Total assets	2,527,465	2,354,266	1,860,758	1,501,970	1,279,974

Per ordinary share

	US\$	US\$	US\$	US\$	US\$
Basic earnings	0.47	1.65	1.40	1.36	1.18
Diluted earnings	0.47	1.63	1.39	1.35	1.17
Dividends	0.93	0.87	0.76	0.69	0.63
Net asset value at year-end ¹⁶	7.44	10.72	9.24	8.03	7.66

Share information

US\$0.50 ordinary shares in issue (millions)	12,105	11,829	11,572	11,334	11,172
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	%	%	%	%	%
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Financial ratios

Dividend payout ratio ¹⁷	197.9	52.7	54.3	50.7	53.4
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Post-tax return on average total assets	0.26	0.97	1.00	1.06	1.14
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Return on average total shareholders' equity	4.7	15.9	15.7	16.8	16.3
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Loans and advances to customers as a percentage of customer accounts	83.6	89.5	96.8	100.1	97.1
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Average total shareholders' equity to average total assets	4.87	5.69	5.97	5.96	6.35
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Capital ratios¹

Tier 1 ratio	8.3	9.3	9.4	9.0	8.9
Total capital ratio	11.4	13.6	13.5	12.8	12.0

Foreign exchange translation rates to US\$

Closing £:US\$1	0.686	0.498	0.509	0.581	0.517
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□ □:US\$1	0.717	0.679	0.759	0.847	0.733
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Average £:US\$1	0.545	0.500	0.543	0.550	0.546
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□ □:US\$1	0.684	0.731	0.797	0.805	0.805
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For footnotes, see page 5.

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Consolidated Financial Statements

The consolidated financial statements of HSBC and the separate financial statements of HSBC Holdings have been prepared in accordance with International Financial Reporting Standards (IFRSs) as issued by the International Accounting Standards Board (IASB) and as endorsed by the European Union (EU). EU-endorsed IFRSs may differ from IFRSs as issued by the IASB if, at any point in time, new or amended IFRSs have not been endorsed by the EU. At 31 December 2008, there were no unendorsed standards effective for the year ended 31 December 2008 affecting these consolidated and separate financial statements, and there was no difference between IFRSs endorsed by the EU and IFRSs issued by the IASB in terms of their application to HSBC. Accordingly, HSBC's financial statements for the year ended 31 December 2008 are prepared in accordance with IFRSs as issued by the IASB.

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

When reference to underlying or underlying basis is made in tables or commentaries, comparative information has been expressed at constant currency (see page 23) and adjusted for the effects of acquisitions and disposals. A reconciliation of reported and underlying profit before tax is presented on page 22.

Footnotes to Financial Highlights

- 1 *The calculation of capital resources, capital ratios and risk-weighted assets for 31 December 2008 is on a Basel II basis. Comparatives are on a Basel I basis.*
- 2 *Dividends recorded in the financial statements are dividends per ordinary share declared in a year and are not dividends in respect of, or for, that year. First, second and third interim dividends for 2008, each of US\$0.18 per ordinary share, were paid on 9 July 2008, 8 October 2008 and 14 January 2009, respectively. Note 12 on the Financial Statements provides more information on the dividends declared in 2008. On 2 March 2009 the Directors declared a fourth interim dividend for 2008 of US\$0.10 per ordinary share in lieu of a final dividend, which will be payable to ordinary shareholders on 6 May 2009 in cash in US dollars, or in pounds sterling or Hong Kong dollars at exchange rates to be determined on 27 April 2009, with a scrip dividend alternative. The reserves available for distribution at 31 December 2008 were US\$18,838 million. Quarterly dividends of US\$15.50 per 6.20 per cent non-cumulative Series A US dollar preference share, equivalent to a dividend of US\$0.3875 per Series A ADS, each of which represents one-fortieth of a Series A dollar preference share, were paid on 17 March 2008, 16 June 2008, 15 September 2008 and 15 December 2008. Quarterly coupons per 8.125 per cent capital securities of US\$0.541 and US\$0.508 were paid on 15 July 2008 and 15 October 2008 respectively.*
- 3 *The definition of return on average invested capital and a reconciliation to the equivalent GAAP measures are set out on page 19.*
- 4 *The return on average total shareholders' equity is defined as profit attributable to shareholders of the parent company divided by average total shareholders' equity.*
- 5 *The cost efficiency ratio is defined as total operating expenses divided by net operating income before loan impairment charges and other credit risk provisions.*
- 6 *This footnote is intentionally left blank.*
- 7 *Each American Depositary Share (ADS) represents five ordinary shares.*
- 8 *Total shareholder return is defined on page 19.*
- 9 *The Financial Times Stock Exchange 100 Index.*
- 10 *The Morgan Stanley Capital International World Index.*
- 11 *The Morgan Stanley Capital International World Bank Index*
- 12 *Data for 2004 exclude the provisions of IAS 32, IAS 39 and IFRS 4, which were adopted with effect from 1 January 2005.*
- 13 *Capital resources are total regulatory capital, the calculation of which is set out on page 278.*
- 14 *Includes perpetual preferred securities, details of which can found in Note 32 on the Financial Statements.*
- 15 *Net of impairment allowances.*
- 16 *The definition of net asset value per share is total shareholders' equity, less non-cumulative preference shares and capital securities, divided by the number of ordinary shares in issue.*
- 17 *Dividends per share expressed as a percentage of earnings per share.*

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HSBC HOLDINGS PLC

Cautionary Statement Regarding Forward-Looking Statements

Cautionary Statement

The *Annual Report and Accounts 2008* contains certain forward-looking statements with respect to the financial condition, results of operations and business of HSBC.

Statements that are not historical facts, including statements about HSBC's beliefs and expectations, are forward-looking statements. Words such as "expects", "anticipates", "intends", "plans", "believes", "seeks", "estimates", "potential" and "reasonably possible", variations of these words and similar expressions are intended to identify forward-looking statements. These statements are based on current plans, estimates and projections, and therefore undue reliance should not be placed on them. Forward-looking statements speak only as of the date they are made, and it should not be assumed that they have been revised or updated in the light of new information or future events.

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

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

- changes in general economic conditions in the markets in which HSBC operates, such as:
 - continuing or deepening recessions and fluctuations in employment;
 - changes in foreign exchange rates, in both market exchange rates (for example, between the US dollar and pound sterling) and government-established exchange rates (for example, between the Hong Kong dollar and US dollar);
 - volatility in interest rates;
 - volatility in equity markets, including in the smaller and less liquid trading markets in Asia and Latin America;
 - lack of liquidity in wholesale funding markets;
 - illiquidity and downward price pressure in national real estate markets, particularly consumer-owned real estate markets;
 - the length and severity of current market turmoil;
 - the impact of lower than expected investment returns on the funding of private and public sector defined benefit pensions;
 - the effect of unexpected changes in actuarial assumptions on longevity which would influence the funding of private and public sector defined benefit pensions; and

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- consumer perception as to the continuing availability of credit, and price competition in the market segments served by HSBC.
- changes in government policy and regulation, including:
 - the monetary, interest rate and other policies of central banks and other regulatory authorities, including the UK Financial Services Authority, the Bank of England, the Hong Kong Monetary Authority, the US Federal Reserve, the US Securities and Exchange Commission, the US Office of the Comptroller of the Currency, the European Central Bank, the People's Bank of China and the central banks of other leading economies and markets where HSBC operates;
 - expropriation, nationalisation, confiscation of assets and changes in legislation relating to foreign ownership;
 - initiatives by local, state and national regulatory agencies or legislative bodies to revise the practices, pricing or responsibilities of financial institutions serving their consumer markets;
 - changes in bankruptcy legislation in the principal markets in which HSBC operates and the consequences thereof;
 - general changes in government policy that may significantly influence investor decisions, in particular in markets in which HSBC operates, including financial institutions newly taken into state ownership on a full or partial basis;
 - extraordinary government actions as a result of current market turmoil;

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- 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.
 - the success of HSBC in addressing operational, legal and regulatory and litigation challenges.

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HSBC HOLDINGS PLC

Group Chairman's Statement

Group Chairman's Statement

2008 was the most extraordinary year for the global economy and financial services in well over half a century. It marked the first crisis of the era of globalised securitisation. And it also marked the first crisis of the just-in-time global economy as the impact of the financial crisis fed rapidly straight into the performance of the real economy.

Causes of the crisis

The causes of the crisis are complex and interrelated. But we can clearly see that a number of different factors contributed:

- First, the global financial imbalances that arose from the accelerating global economic shift towards emerging markets. The rapid growth of emerging economies created a macro-economic triangle, made up of: the major consumer markets, in particular the US but also a number of other Western economies; major producer nations – notably a number of fast-growing emerging markets which have been manufacturing a vast range of goods for consumption in the West; and resource providers whose wealth of hydrocarbons and other commodities have helped power the producer economies and have thus commanded such high prices until recently. This macro-economic triangle delivered high rates of growth, but also created major financial imbalances as producer nations and resource providers accumulated massive reserves whilst the US and other consumer markets ran significant and growing deficits.
- Second, cheap credit. A large proportion of the accumulated savings of the producers and resource providers was invested in the world's reserve currency, the US dollar, keeping rates low. This cheap money fuelled a consumer boom and rising house prices. It encouraged increased borrowing by banks and by their customers, fuelling asset price bubbles particularly in housing markets. Loose monetary conditions in the US and in much of the emerging world gave added strength to this already potent cocktail.

- Third, securitisation based on overly complex product structures. The complexity and opacity of certain financial instruments reached a point where even senior and experienced bankers and professional investors had trouble understanding them. This meant that people were selling and buying assets whose risks they had not properly assessed.
- And finally, excessive gearing. Many banks became overgeared and too dependent on wholesale funding, which they assumed, incorrectly, would never dry up. Assets were created on the back of ever higher leverage, both direct and indirect. And when the securitisation market began to collapse, banks found themselves with assets that they could neither sell nor fund, so forcing large losses on the asset side and a funding challenge on the liability side for which they were entirely unprepared.

The result has been unprecedented stress in the financial system, and it has led to a major breakdown in trust. In many countries, huge support from taxpayers has been required in order to stabilise the system.

Failings in the banking industry

The industry has done many things wrong. It is important to remember that many ordinary bankers have always sought to provide good service to their customers; but we must also recognise that there have been too many who have profoundly damaged the industry's reputation.

Inappropriate products were sold inappropriately by many. Compensation practices ran out of control and perverse incentives led to dangerous outcomes. There is genuine and widespread anger that the contributors to the crisis were in some cases amongst the biggest beneficiaries of the system.

Underlying all these events is a question about the culture and ethics of the industry. It is as if, too often, people had given up asking whether something was the right thing to do, and focused only whether it was legal and complied with the rules. The industry needs to recover a sense of what is right and suitable as a key impulse for doing business.

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HSBC strategy intact

We at HSBC were not immune from the crisis. But we have built our business on very strong foundations and are able to report results which demonstrate our ability to withstand the storm.

Our strategy has been tested and remains intact. We will continue to build our business by focusing on faster-growing markets around the world and on businesses where international connectivity is important – all from a position of financial strength. If anything, the current crisis validates our renewed focus over the last few years on fast-growing economies, since it will accelerate the shift in the world's centre of economic gravity from west to east.

Our robust balance sheet and liquidity means that we have continued to lend. In 2008, we grew our lending to commercial customers by 10 per cent on an underlying basis. Lending to personal customers increased in all regions except North America. And our brand strength continues to underpin our performance. It was noticeable that, at times of stress in many markets, HSBC was a beneficiary of funds flowing in. Recently, the HSBC brand was recognised as the number one brand in banking by Brand Finance.

Profitable from a broad-based earnings platform

Excluding the goodwill impairment on our North America Personal Financial Services business, HSBC reported a pre-tax profit for 2008 of US\$19.9 billion, a decline of 18 per cent. On a reported basis, pre-tax profit was US\$9.3 billion, down 62 per cent. Within this were some strong regional and business line performances. However, there is one area on which I would like to comment.

For North America, we reported a loss of US\$15.5 billion including the goodwill impairment charge of US\$10.6 billion in Personal Financial Services. The significant deterioration in US employment and economic outlook in the fourth quarter of 2008 were the primary factors in causing us to write off all the remaining goodwill carried on our balance sheet in respect of our Personal Financial Services business in North America.

The management team has worked tirelessly to address this problem acquisition in the US and we have considered all viable options. We saw the disruption in sub-prime lending as early as 2006 and sharply scaled back in 2007 while others continued

to grow. We also devoted considerable resources to helping our customers. Virtually no one then foresaw the subsequent scale of the deterioration in the US economy and financial markets. It is now clear that models of direct personal lending that depend on wholesale markets for funding are no longer viable. In light of this, we have taken the difficult decision that, with the exception of credit cards, we will write no further consumer finance business through the HFC and Beneficial brands in the US and close the majority of the network. Thus, in terms of new business, we are drawing a line and we will run off our existing business, providing all necessary support to HSBC Finance to enable it to do so in a measured way and meet all its commitments.

HSBC has a reputation for telling it as it is. With the benefit of hindsight, this is an acquisition we wish we had not undertaken.

The US remains the world's largest economy and HSBC remains committed to the US, which we see as a core market for HSBC. HSBC Bank in the US is not affected by the restructure. In the immediate future we will focus on those businesses and customers for whom our global connectivity gives us advantage – primarily in corporate and commercial business, and in Private and Premier banking.

Performance overview and strategic activity

In this difficult environment, we missed our profitability targets. We hit our capital target with our tier 1 ratio at 8.3 per cent. We maintained a very conservative advances-to-deposits ratio at 84 per cent. We grew lending in each region outside North America on an underlying basis. And we constrained costs, with the cost efficiency ratio improving to 47.2 per cent, excluding the goodwill impairment mentioned above. We also continued implementation of OneHSBC, our programme to enhance customer experience and improve cost efficiency

through standardising products, processes and technology around the world.

We also acquired businesses in strategic areas □ we acquired the assets, liabilities and operations of The Chinese Bank in Taiwan in March; IL&FS Investsmart, a retail brokerage in India in May; and, in October, the acquisition of Bank Ekonomi in Indonesia was announced. The first two are complete and being integrated, the last is expected to be completed in the second quarter. The most notable disposal was the sale of our regional bank network in France for a consideration of US\$3.2 billion.

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HSBC HOLDINGS PLC

Group Chairman's Statement(continued)

Group Chairman's Statement

Thank you to our people

This was an extraordinary year and made extraordinary demands on many of our people. I want to express my sincere thanks for all their efforts and achievements. Our industry has rightly been under considerable public scrutiny and banks have been indiscriminately bunched together. It is through our staff that HSBC's distinctive character stands out for our customers and it is they who ensure that not all banks are the same.

Dividend declaration and progressive dividend policy

The Directors have declared a fourth interim dividend for 2008 of US\$0.10 per ordinary share (in lieu of a final dividend) which, together with the first three interim dividends for 2008 of US\$0.18 already paid, will make a total distribution in respect of the year of US\$0.64 per ordinary share. The payments in total represent a decrease of 29 per cent in US dollar terms compared with 2007 and of 15 per cent in sterling terms. The dividend will be payable on 6 May 2009 to shareholders on the register at the close of business on 20 March 2009.

After 15 years of double-digit dividend growth, we did not make the decision to lower the dividend lightly. Very careful consideration was given to the current operating environment and the increased uncertainty over both the supply of capital required in an increasingly volatile financial world and a pro-cyclical regulatory capital framework.

For 2009, HSBC has rebased the envisaged dividend per share for the first three interim dividends to US\$0.08 to reflect the impact of the enlarged ordinary share capital following the Rights Issue we are announcing today, prevailing business conditions and capital requirements. The dividend payments remain substantial and reflect management's long-term confidence in the business. HSBC will continue to aim to pay progressive dividends in line with the long-term growth of the business.

Maintaining HSBC's financial strength

The logic of maintaining HSBC's distinctive financial strength which we have applied to our dividend also applies to our capital position. We have announced today a Rights Issue to strengthen further our capital ratios. We propose to raise, on a fully underwritten basis, approximately US\$17.7 billion of equity which will increase our capital ratios by 150 basis points, strengthening the core equity tier 1 ratio to 8.5 per cent and the tier 1 ratio to 9.8 per cent, both on a pro forma basis as at

31 December 2008. I shall be writing to all shareholders with full details.

Over the past 12 months, many of our competitors have received significant government capital injections or something we said we could not envisage or have raised capital from shareholders and other investors. Higher regulatory capital requirements, in part from the effect of the economic downturn on capital requirements under the Basel II regime, as well as changing market sentiment on appropriate levels of leverage, have also raised expectations regarding capital levels. We are determined that HSBC should maintain its signature financial strength and we are now raising the top of our target range for the tier 1 ratio so that the range will be from 7.5 per cent to 10 per cent.

Planned internal capital generation remains strong and this capital raising will enhance our ability to deal with the impact of an uncertain economic environment and to respond to unforeseen events. Importantly, it will also give us options with respect to opportunities which we believe will present themselves to those with superior

financial strength. These may involve organic investment in the continued taking of market share from more capital constrained competitors. There may also be opportunities to grow through targeted acquisitions by taking advantage of attractive valuations where the opportunities in question align with our strategy and the risks are understood.

Culture and compensation

We believe in the profound importance of culture and ethics in business. HSBC's longstanding traditions of financial strength, long-term customer relationships and conservative management are as important today as ever. They have not always been fashionable and we have not always been perfect. One of the consequences of the crisis – and rightly so – is that we are going to see a fundamental re-evaluation of the rules and regulations that govern our business. But we should remember that no amount of rules and regulations will be sufficient if the culture does not encourage people to do the right thing. It is the responsibility of Boards to supervise and management to embed a sustainable culture into the very fibre of the organisation. For HSBC, there is nothing more important.

We also intend to play our part in rebuilding public trust in our industry. This means we must be willing to take part in and shape the debate on how our industry should evolve in the coming years, based on the lessons which must be learnt from this crisis. In particular, we strongly believe that the

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industry must respond to the requirement for a more sober and reasonable approach to compensation. At HSBC, we are committed to the principle of sensible market-related pay, structured to align executive actions with long-term shareholder interests. A small number of individuals in a market system will inevitably receive compensation that is high in absolute terms, but this must be genuinely linked to long-term shareholder interests. It is clear that the banking industry got it wrong in the go-go years: we will play our part in helping the industry respond appropriately to the new realities.

It is right therefore that in HSBC's case, I outline our present position. As Chairman I elected in 2007 to no longer receive any cash bonus award; any variable compensation would be delivered through performance share awards which would only vest if performance hurdles are met. And no performance share awards will be made in the Group in respect of 2008. Mike Geoghegan, Group Chief Executive, and Stuart Gulliver, Chief Executive Global Banking and Markets, and Douglas Flint, Group Finance Director, have asked the Remuneration Committee not to consider them for any bonus award for 2008. No cash bonus award will be made to any Executive Director for 2008. Full details on Directors' remuneration can be found in the *Annual Report*.

Learning the lessons

We are living through a genuinely global crisis; it cannot be solved by one nation alone. Governments need to work together with our industry to tackle the root causes of the crisis, while maintaining the open, globalised markets that have helped spread prosperity in the last two decades. Protectionism, both in trade and in capital flows, is a threat and in all its forms must be resisted.

We must also urgently improve governance and regulation to create a more stable financial framework. The globalisation of financial markets contrasts sharply with the domestic agenda of the regulatory regimes that underpin it. We support intergovernmental efforts to enhance the coordination of regulatory oversight, since we believe that this is essential to the stable development of the international capital markets for the benefit of the common good.

Continued economic strain

The coming twelve months will be difficult. We expect parts of Asia, the Middle East and Latin America to continue to outperform Western economies, but to be constrained by the global downturn.

We see unemployment rising through 2009 into 2010 in both the US and the UK, together with continuing declines in housing markets. We should remember that the US is the driver of the global economy and global growth depends on the US recovery.

We remain confident that HSBC is well-placed in today's environment and that our strength leads to opportunity. Our strategy has served HSBC well and positions it for long-term growth with attractive returns. HSBC continues to combine its position as the world's leading emerging markets bank with an extensive international network across both developed and faster growing markets. At the same time, as the financial system exhibits stress, our competitive position is improving as the capacity and capabilities of financial institutions are constrained by lack of capital and funding; many of them are also focusing more on their domestic markets.

Further strengthening our capital base will enhance our ability to deal with the impact of an uncertain economic environment and to respond to unforeseen events, as well as giving us options regarding opportunities which will undoubtedly present themselves to those with superior financial strength.

S K Green, *Group Chairman*
2 March 2009

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review

Principal activities / Strategic direction / Challenges and uncertainties

Principal activities

HSBC is one of the largest banking and financial services organisations in the world, with a market capitalisation of US\$114 billion at 31 December 2008.

Through its subsidiaries and associates, HSBC provides a comprehensive range of banking and related financial services. Headquartered in London, HSBC operates through long-established businesses and has an international network of some 10,000 properties in 86 countries and territories in five geographical regions: Europe; Hong Kong; Rest of Asia-Pacific, including the Middle East and Africa; North America and Latin America. Within these regions, a comprehensive range of financial services is offered to personal, commercial, corporate, institutional, investment and private banking clients. Services are delivered primarily by domestic banks, typically with large retail deposit bases, and consumer finance operations. Taken together, the five largest customers of HSBC do not account for more than one per cent of HSBC's income.

There were no significant acquisitions during the year (for details of acquisitions see page 418). HSBC disposed of its seven French regional banks for US\$3.2 billion in July 2008 (see pages 418 and 458).

Strategic direction

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

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

HSBC is, therefore, continuing to invest primarily in the faster growing markets and, in the more developed markets, by focusing on businesses which have international connectivity. Central to these reshaping activities is a policy of maintaining HSBC's capital strength and strong liquidity position.

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

- businesses with international customers for whom developing markets connectivity is crucial – Global Banking and Markets, Private Banking, the large business segment of Commercial Banking and the mass affluent segment of Personal Financial Services;

- businesses with local customers where efficiency can be enhanced through global scale – the small business segment of Commercial Banking and the mass market segment of Personal Financial Services; and
- products where global scale is possible through building efficiency, expertise and brand – global product platforms such as global transaction banking.

The means of executing the strategy, and further utilising the linkages within the Group, are clear:

- the HSBC brand and global networks will be leveraged to reach new customers and offer further services to existing clients;
- efficiency will be enhanced by taking full advantage of local, regional and global economies of scale, in particular by adopting a common systems architecture wherever possible; and
- objectives and incentives will be aligned to motivate and reward staff for being fully engaged in delivering the strategy.

Challenges and uncertainties

Current economic and market conditions may adversely affect HSBC's results.

The global economy has entered the most severe downturn for 80 years, with the financial services industry facing extraordinary turbulence. A shortage of liquidity, lack of funding, pressure on capital and extreme price volatility across a wide range of asset classes are putting financial institutions under considerable pressure. This is leading governments and central banks to undertake unprecedented intervention designed to stabilise the global and

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domestic financial systems, to stimulate new lending and to support systemically important institutions at risk of failing. Many developed economies have entered recession and growth has slowed in many emerging countries, with serious adverse consequences for asset values, employment, consumer confidence and levels of economic activity. Commodity prices have significantly retrenched, in many cases from recent historical highs, interest rate yield curves have flattened, interest rates have fallen in absolute terms and trade flows have contracted. Global equity markets have experienced severe declines and various currencies, including sterling, have depreciated significantly against the US dollar. Emerging markets have suffered as portfolio investments have been repatriated and cross-border inter-bank funding has been withdrawn. Numerous governments and central banks have responded by proposing programmes to make substantial funds and guarantees available to boost liquidity and confidence in their financial systems, as well as cutting taxes and lowering interest rates. It is not known whether these responses will be effective in addressing the severe economic and market conditions or whether recently proposed measures will be implemented as initially proposed.

HSBC's earnings are affected by global and local economic and market conditions. Dramatic declines in 2007 and 2008 in the housing markets in the US, the UK and elsewhere have combined with increasing unemployment to affect negatively the credit performance of real estate-related exposures, resulting in significant write-downs of asset values by financial institutions, including HSBC. These write-downs, initially of asset-backed securities but spreading to other securities and loans, have caused many financial institutions to seek additional capital, to reduce or eliminate dividends, to merge with larger and stronger competitors or, in some cases, to fail.

A worsening of these conditions may exacerbate the impact of these difficult market conditions on HSBC and other financial institutions and could have an adverse effect on HSBC's operating results. In particular, the Group may face the following challenges in connection with these events:

- HSBC's ability to assess the creditworthiness of its customers or to estimate the values of its assets may be impaired if the models and techniques it uses become less accurate in their predictions of future behaviour, valuations or estimates. The process HSBC uses to estimate losses inherent in its credit exposure or assess the value of certain assets requires difficult, subjective and complex judgements. These include forecasts of economic conditions and how predicted economic scenarios might impair the ability of HSBC's borrowers to repay their loans or might affect the value of assets. As a consequence, this process may be less capable of making accurate estimates which, in turn, may undermine the reliability of the process.
- The demand for borrowing from creditworthy customers may diminish as economic activity slows.
- Lower interest rates will reduce net interest income earned by HSBC on its excess deposits.
- HSBC's ability to borrow from other financial institutions or to engage in funding transactions on favourable terms, or at all, could be adversely affected by further disruption in the capital markets or deteriorating investor sentiment.
- Market developments may affect consumer confidence and may cause declines in credit card usage and adverse changes in payment patterns, leading to increases in delinquencies and default rates, write-offs and loan impairment charges beyond HSBC's expectations.
- Loan impairment allowances and write-offs are likely to rise as a result of a deterioration in payment patterns and increased delinquencies and default rates caused by weakening consumer confidence and increased business failures. A worsening of these economic factors may exacerbate the adverse effects of these difficult market conditions on HSBC and others in the financial services industry.
- HSBC expects to face increased regulation and supervision of the financial services industry, following new or proposed regulatory measures in countries in which it operates.
- Trade and capital flows may further contract as a result of protectionist measures being introduced in certain markets.

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- Increased government ownership and control over financial institutions and further consolidation in the financial industry, which could significantly alter the competitive landscape.

As a worldwide financial institution, HSBC is exposed to these developments across all its businesses, both directly and through their impact on its customers and clients. Local variations exist, however, reflecting regional circumstances and

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HSBC HOLDINGS PLC

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

Challenges and uncertainties

presenting challenges to HSBC which are specific to those areas.

Europe

In the UK, the economy has entered recession and the currency has fallen in value against the US dollar, the yen and the euro. Changes in the marketplace are emerging following the part-nationalisation of some major financial institutions, and political interaction with the regulatory environment is becoming more frequent as the government seeks to stimulate lending to preserve economic activity. A period of low interest rates will reduce deposit spreads and HSBC's retail business model will be more dependent on transactional fees and lending margin. Pension funding requirements, in particular for UK defined benefit schemes, will place increased financing demands on corporates, which may lead to unfunded commitments being drawn down, adding to pressure on system liquidity. The recent deterioration in credit quality is expected to continue as the economy contracts, with loan impairment charges rising as a result. Market volatility is also expected to continue.

In France, changes in the marketplace are slowly emerging following government measures to stimulate lending and preserve economic activity. A period of low interest rates will not adversely impact spreads in the short-term but will have an adverse effect in later years. HSBC's retail business model is dependent on banking fees to maintain profitability and a recovery in financial markets is necessary in order to enhance brokerage and management fees and stimulate fund management activities. Deterioration in credit quality is expected to continue as the economy contracts, with commercial loan impairment charges rising as a result. Personal loan impairment charges are expected to remain at around current levels unless there is a very deep recession.

Conditions are likely to remain difficult in a number of markets in which HSBC currently trades and volatility is expected to continue.

Hong Kong and Rest of Asia-Pacific

In Asia-Pacific, a prolonged period of low interest rates is expected which will put pressure on HSBC's net interest income from its strong deposit base. With capital market and currency volatility endemic, customers are likely to seek capital protection and become increasingly rate and risk sensitive, seeking out products which offer deposit insurance and government guarantees. Regulatory reforms in the areas of wealth management product complexity,

sales requirements and liquidity and reserve ratios are likely, and these will lead to a higher cost of compliance, greater standardisation and slower product approvals. International trade is expected to continue to contract, affecting import and export volumes and reducing HSBC's earnings from trade financing. The quality of the asset book will deteriorate if economic factors beyond HSBC's control do not improve, reducing customer credit ratings and, as a consequence, increasing risk-weighted asset allocations and capital requirements. This could be exacerbated if capital continues to be repatriated from emerging markets to more developed economies to take advantage of lower asset prices, adversely affecting emerging markets' balance of payments and foreign exchange reserves. However, Asia is expected to adapt quickly to secure recovery from the global recession, led by mainland China and India.

The fall in global demand for oil products and related prices, and the contraction in financial surpluses held by key oil-producing countries following the declines in capital markets, will reduce the ability of some countries in the Middle East to maintain spending, borrowing and investment domestically and internationally. This will result in the cancellation or postponement of infrastructure projects which, together with weakening property

prices, is expected to reduce both credit cover and revenue streams for financial institutions. The availability of economically priced, long-term funding is likely to contract. Business activity and private investment will also slow as consumer confidence declines. These factors will combine to place pressure on net revenues and on capital requirements.

North America

In the US, the steep decline in the housing market, with falling home prices and increasing foreclosures, and rising unemployment have resulted in significant write-downs of loans and advances and mortgage-backed securities. The effect of these write-downs subsequently spread to other capital market activities, leading many financial institutions to seek additional capital, merge with larger and stronger institutions and, in some cases, fail. Many lenders reduced or stopped providing funding to borrowers, including to other financial institutions. This market turmoil and resultant tightening of credit have led to an increased level of delinquencies, a fall in consumer confidence, increased market volatility and a widespread reduction in business activity in general. To date, various government intervention measures designed to stabilise the markets, including

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the decision of the Federal Reserve to reduce interest rates to unprecedentedly low levels, appear to be having an impact on the trading of both guaranteed and non-guaranteed debt in early 2009. A prolonged period of low Federal funds rates will put pressure on deposit spreads earned on HSBC's deposit base. It is likely that these conditions will continue to adversely affect the Group's results into 2010, the degree to which remains uncertain.

Latin America

Markets in Latin America are expected to be affected by recession in the developed world, particularly in the US. Output will fall as a decline in the demand for exports will adversely affect the export sector, and these factors are likely to combine with currency volatility to weaken the balance sheets of financial institutions. This may lead to a further contraction in the availability of credit, increasing the likelihood of bankruptcies and unemployment and reducing economic activity and consumption. Lower commodity prices and reduced remittance inflows are likely to affect economies in the region, particularly in Mexico and Central America. Exchange rates are likely to remain under pressure as growth stalls, and inflation may rise. The possibility of a combined credit crunch and stagflation in Latin America cannot be ruled out. The authorities may react with stricter prudential regulation and price controls. Public finances will come under strain if oil and other commodity prices remain low, restricting the authorities' room for manoeuvre.

Risks associated with liquidity and funding, which are inherent in HSBC's business, have been greatly increased by the current global market conditions

HSBC's business model depends upon its ability to access financial resources whenever required to meet its obligations. To this end, HSBC seeks to maintain a diversified and stable funding base comprising core retail and corporate customer deposits and institutional balances and to augment this with wholesale funding and portfolios of highly liquid assets diversified by currency and maturity which are held to enable HSBC to respond to unforeseen liquidity requirements. HSBC's earnings are affected by its ability to properly value financial instruments. In certain illiquid markets, determining the value at which financial instruments can be realised is highly subjective, and processes to ascertain value and estimates of value, both of which require substantial elements of judgement, assumptions and estimates (which may change over time), are required. Increased illiquidity adds to

uncertainty over the accessibility of financial resources and may reduce capital resources as valuations decline. Rating agencies, which determine HSBC's own credit ratings and thereby influence the Group's cost of funds, take into consideration management effectiveness and the success with which HSBC's liquidity risk factors are managed. Actions by third parties and independent market participants, such as rating agency downgrades of instruments to which HSBC has exposure, can result in reduced liquidity and valuations of those instruments. HSBC's liquidity could also be constrained by an inability to access the debt capital markets due to a variety of unforeseen market dislocations or interruptions.

The extreme market conditions facing the financial services industry have been reflected in shortages of liquidity, lack of funding, pressure on capital and extreme price volatility across a wide range of asset classes. Illiquidity of these assets has prevented the realisation of existing asset positions and has constrained risk distribution in ongoing banking activities. The extreme market conditions, which have highlighted the importance of a strong diversified core deposit base, have also led to increased competition for such deposits and the risk of deposit migration. HSBC's Global Banking and Markets business operates in the markets affected by illiquidity and extreme price volatility, either directly or indirectly, through exposures to securities, loans, derivatives and other commitments, and HSBC has made substantial write-downs and impairments on illiquid legacy credit and structured credit positions. While it is difficult to predict how long the conditions described above will exist and which of HSBC's markets, products and other businesses will be affected, continuation of these factors could have an adverse effect on the Group's results.

HSBC has significant exposure to counterparty risk

HSBC's ability to engage in routine transactions to fund its operations and manage its risks could be adversely affected by the actions and commercial soundness of other financial services institutions. Financial institutions are extremely interdependent because of trading, clearing, counterparty or other relationships. As a consequence, a default by, or decline in market confidence in, individual institutions, or anxiety about the financial services industry generally, can lead to further individual and/or systemic difficulties, defaults and

losses. HSBC has exposure to virtually all major industries and counterparties, and it routinely executes

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HSBC HOLDINGS PLC

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

Challenges and uncertainties / KPIs

transactions with counterparties in financial services, including brokers and dealers, commercial banks, investment banks, mutual and hedge funds, and other institutional clients. Many of these transactions expose HSBC to credit risk in the event of default by its counterparty or client. Where counterparty risk has been mitigated by taking collateral, HSBC's credit risk may be exacerbated if the collateral it holds cannot be realised or has to be liquidated at prices which are insufficient to recover the full amount of its loan or derivative exposure. The failure of one of HSBC's counterparties could have an adverse effect on its results.

HSBC operates in a highly competitive environment, and competition could intensify as a result of current global market conditions

Consolidation in the financial services industry is increasingly concentrating activity in companies that are capable of offering a wide array of financial products at competitive prices, with globalisation exposing HSBC to competition in capital markets and financial services at global and local levels alike. In addition, technological advances, the growth of e-commerce, regulatory developments and public sector participation or guarantees have made it possible for non-depository institutions to offer products and services that traditionally were the preserve of banks. The prominence in recent years of sovereign wealth funds, private equity and hedge funds as alternative sources of funding – which has increased competition for traditional financial institutions – may ease as investors seek safer, more traditional alternatives. Competition may further intensify or the competitive landscape may change as the consolidation of financial services companies continues and others are brought into part or full public ownership in response to the current market conditions. HSBC's ability to grow its businesses, and therefore its earnings, is affected by these competitive pressures and is dependent on HSBC's ability to attract and retain talented and dedicated employees.

HSBC is subject to political and economic risks in the countries in which it operates

HSBC operates through an international network of subsidiaries and affiliates in 86 countries and territories around the world. Its results are therefore subject to the risk of loss from unfavourable political developments, currency fluctuations, social instability and change in government policies on such matters as expropriation, authorisations, international ownership, interest-rate caps, limits

on dividend flows and tax in the jurisdictions in which it operates. These factors may also negatively affect revenues from the trading of securities and investment in securities, the effect being accentuated through certain international trading markets, particularly those in emerging market countries, being typically smaller, less liquid and more volatile than developed trading markets. HSBC's subsidiaries' and affiliates' ability to pay dividends could be restricted by changes to official banking measures, exchange controls and other requirements. Because HSBC prepares its accounts in US dollars, while a substantial part of its assets, liabilities, assets under management, revenues and expenses are denominated in other currencies, changes in foreign exchange rates have an effect on its reported income and shareholders' equity. For a detailed discussion of global and regional factors that impact the results of HSBC's operations, see page 12.

Operational risks are inherent in HSBC's business

HSBC is exposed to many types of operational risk, including fraudulent and other criminal activities (both internal and external), breakdowns in processes or procedures and systems failure or non-availability. HSBC is also subject to the risk of disruption of its business arising from events that are wholly or partially beyond its control (for example natural disasters, acts of terrorism, epidemics and transport or utility failures) which may give rise to losses in service to customers and/or economic loss to HSBC. All of these risks are also applicable where HSBC relies on outside suppliers or vendors to provide services to it and its customers.

HSBC is subject to legal risks, which have an adverse effect on the Group's reputation

The risks to HSBC's reputation arise from a variety of sources with the potential to cause harm to the Group and its ability to operate. These issues require the Group to deal appropriately with potential conflicts of interest; legal and regulatory requirements; ethical issues; anti-money laundering laws or regulations; privacy laws; information security policies; sales and trading practices; and the conduct of companies with which it is associated. Failure to address these issues appropriately may give rise to additional legal and compliance risk to HSBC, with an increase in the number of litigation claims and the amount of damages asserted against HSBC, or subject HSBC to regulatory enforcement actions, fines or penalties.

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Increased regulation of the financial services industry could have an adverse effect on HSBC's operations

HSBC, its subsidiaries and its affiliates are subject to extensive and increasing regulation, accounting standards and interpretations thereof and legislation in the various countries in which the Group operates. From time to time, new laws are introduced, including tax, consumer protection, privacy and other legislation, which affect the operating environment in which the Group operates. As a result of the recent interventions by governments in response to global economic conditions, it is widely expected that there will be a substantial increase in government regulation and supervision of the financial services industry, including the imposition of higher capital requirements and restrictions on certain types of transaction structure. If enacted, such new regulations could require additional capital to be injected into HSBC's subsidiaries and affiliates, require HSBC to enter into business transactions that are not otherwise part of its current Group strategy, prevent HSBC from continuing current lines of operations, restrict the type or volume of transactions HSBC may enter into, limit HSBC's subsidiaries' and affiliates' ability to declare dividends to HSBC, or set limits on or require the modification of rates or fees that HSBC charges on certain loan or other products. HSBC may also face increased compliance costs and limitations on its ability to pursue business opportunities. Separately, the Basel II Accord's requirement for financial institutions to increase their capital in response to deteriorating market conditions may have secondary effects on lending, which could exacerbate the current market downturn. These measures, alone or in combination, could have an adverse effect on HSBC's operations.

In the UK for example, the Banking Act 2009 includes a "Special Resolutions Regime" which gives wide powers in respect of UK banks and their parent companies to the UK Treasury, the FSA and the Bank of England in circumstances where any such UK bank has encountered, or is likely to encounter, financial difficulties.

HSBC is subject to tax-related risks in the countries in which it operates, which could have an adverse effect on its operating results

HSBC is subject to the substance and interpretation of tax laws in all countries in which it operates.

A number of double taxation agreements entered into between countries also affect the taxation of the Group. Tax risk is the risk associated with changes in tax law or in the interpretation of tax law. It also includes the risk of changes in tax rates and the risk of consequences arising from failure to comply with procedures required by tax authorities. Failure to manage tax risks could lead to increased tax charges, including financial or operating penalties, for not complying as required with tax laws.

Key performance indicators

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

As a prerequisite for the vesting of Performance Shares, the Remuneration Committee must satisfy itself that HSBC Holdings' financial performance has shown a sustained improvement in the period since the award date. In determining this, the Remuneration Committee will take account of all relevant factors but in particular comparisons against the total shareholder return ("TSR") comparator group with regard to the financial key performance indicators ("KPIs") described below.

Financial KPIs

To support the Group's strategy and ensure that HSBC's performance can be monitored, management utilises a number of financial KPIs. The table below presents these KPIs for the period from 2004 to 2008. At a business level, the KPIs are complemented by a range of benchmarks which are relevant to the planning process and to reviewing business performance.

HSBC has published a number of key targets against which future performance can be measured. Financial targets have been set as follows: the return on average total shareholders' equity over the medium term has been

set at 15-19 per cent; the cost efficiency ratio has been set in the range of 48-52 per cent; and the TSR in the top half of that achieved by peers. The cost efficiency ratio has been set as a range within which the business is expected to remain in order to accommodate the need for continued investment in support of future business growth.

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HSBC HOLDINGS PLC

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

KPIs

Financial KPIs □ trend analysis

	2008 %	2007 %	2006 %	2005 %	2004 %
Revenue growth ¹	3.4	20.8	13.4	12.2	□
Revenue mix ²					
Net interest income	52.1	47.8	52.8	54.4	60.6
Net fee income	24.5	27.9	26.3	25.1	25.2
Other income ³	23.4	24.3	20.9	20.5	14.2
Cost efficiency ⁴	60.1	49.4	51.3	51.2	51.6
Credit performance as measured by risk adjusted margin ⁵	4.8	6.0	6.3	6.3	6.8
Return on average invested capital ⁶	4.0	15.3	14.9	15.9	15.0
Dividends per share growth ⁷	(28.9)	11.1	11.0	10.6	10.0
Basic earnings per ordinary share ⁸ (US\$)	0.47	1.65	1.40	1.36	1.18
Return on average total shareholders' equity ⁹	4.7	15.9	15.7	16.8	16.3
	Over 1 year	Over 3 years	Over 5 years		
Total shareholder return					
HSBC TSR	84.5	84.5	98.5		
Benchmarks:					
□ FTSE 100	71.7	88.1	118.3		
□ MSCI World	81.8	93.6	123.7		
□ MSCI Banks	63.0	60.8	82.7		

1 The percentage increase in net operating income before loan impairment and other credit risk charges since the previous year.

2 As a percentage of net operating income before loan impairment charges and other credit risk provisions.

3 Other income comprises net operating income before loan impairment charges and other credit risk provisions less net interest income and net fee income.

4 Total operating expenses divided by net operating income before loan impairment and other credit risk charges.

5 Net operating income divided by average risk-weighted assets.

6 Profit attributable to ordinary shareholders divided by average invested capital.

7 The percentage increase in dividends per share since the previous year, based on the dividends paid in respect of the year to which the dividend relates.

8 Basic earnings per ordinary share is defined in Note 13 on the Financial Statements.

9 The return on average total shareholders' equity is defined as profit attributable to shareholders of the parent company divided by the average total shareholders' equity.

Revenue growth provides an important guide to the Group's success in generating business. In 2008, total revenue grew by 3.4 per cent to US\$81.7 billion, 2.1 per cent on an underlying basis, reflecting the resilience of HSBC's income generating capabilities in these exceptionally difficult economic circumstances.

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 between 2005 and 2007 shows a trend of net fee income increasing at a faster rate than net interest income. This trend has been reversed in 2008 as net fee income's contribution fell by 3.4 percentage points mainly due to lower fees on cards and equity-related products.

Cost efficiency is a relative measure that indicates the consumption of resources in generating revenue. Management uses this to assess the success of technology utilisation and, more generally, the productivity of the Group's distribution platforms and sales forces. The cost efficiency ratio for 2008 deteriorated by 10.7 percentage points to 60.1 per cent. This included writing off goodwill in the US.

Credit performance as measured by risk-adjusted margin is an important gauge for assessing whether credit is correctly priced so that the returns available after recognising impairment charges meet the Group's required return parameters. The ratio for 2008 was 4.8 per cent, showing a decline of 1.2 percentage points over 2007, as loan impairment charges rose at a faster rate than income on higher average risk-weighted assets.

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Return on average invested capital measures the return on the capital investment made in the business, enabling management to benchmark HSBC against competitors. In 2008, the ratio of 4.0 per cent was 11.3 percentage points lower than that reported in 2007. This decrease reflected the decline in profit driven by goodwill impairment, the significant increase in loan impairment charges, write-downs in credit trading, leveraged and acquisition finance, and monoline exposures. The comparative period included dilution gains which were not repeated.

HSBC aims to deliver sustained **dividend per share growth** for its shareholders. The total dividend for 2008, based on the year to which the dividends relate (rather than when they were paid), amounts to US\$0.64, a reduction of 28.9 per cent on 2007, reflecting the decline in profitability, prevailing business conditions and capital requirements. This basis differs from the disclosure in the five-year comparison on page 4.

Basic earnings per share (EPS) is a ratio that shows the level of earnings generated per ordinary share. EPS is one of two KPIs used in rewarding employees and is discussed in more detail in the Director's Remuneration Report on page 315. EPS for 2008 was US\$0.47, a decline of 71.5 per cent on 2007. This, in part, reflected the effect of recognising goodwill impairment in North America as well as the broad based impact of the global economic crisis. In 2007, EPS grew by 17.9 per cent over that reported in 2006.

Return on average total shareholders' equity measures the return on average shareholders' investment in the business. This enables management to benchmark Group performance against competitors and its own targets. In 2008, the ratio was 4.7 per cent or 11.2 percentage points lower than in 2007 of which 8.6 percentage points related to the goodwill impairment recognised. This absolute performance is not regarded as satisfactory, being lower than management's target range of between 15 and 19 per cent.

Total shareholder return (TSR) is used as a method of assessing the overall return to shareholders on their investment in HSBC, and is defined as the growth in share value and declared dividend income during the relevant period. TSR is a key performance measure in rewarding employees. In calculating TSR, dividend income is assumed to be invested in the underlying shares. 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. As the comparator group includes companies listed on overseas markets, a common currency is used to ensure that TSR is measured on a consistent basis. The TSR levels at the end of 2008 were 84.5, 84.5, and 98.5 over one, three and five years respectively. HSBC's TSR over all periods, while disappointing in absolute terms, has significantly outperformed the peer group as the current financial crisis has had a significantly more adverse impact on their performance and rating.

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

Non-financial KPIs

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

Employee engagement

Employee engagement is a measure of employees' emotional and rational attachment to HSBC. It is critical to the long-term success of the Group and, as such, an employee engagement target was included in the 2008 objectives for Group Executives (see Directors' Remuneration Report, page 315).

In 2008, HSBC conducted its second Global People Survey of HSBC's permanent workforce worldwide. The 2008 participation rate of 93 per cent improved on the 2007 figure of 88 per cent, which was already around the highest in the industry.

The Group's employee engagement score rose from 60 per cent in 2007 to 67 per cent in 2008. In achieving 67 per cent, HSBC exceeded its target for 2008 of 62 per cent, the external global norm and the sector norm. Its 2009 target is 69 per cent.

The 2008 survey covered 13 dimensions which included assessing for the first time whether action had been perceived to have been taken on the results of the 2007 survey. Employees rated HSBC above the external global norm across all dimensions. HSBC exceeded the external best-in-class norm for Corporate Sustainability, and the dimensions covering Strategy and Vision, Reputation, Direct Manager and Leadership were close to this norm.

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HSBC HOLDINGS PLC

Report of the Directors: Business Review

(continued)

Reconciliation of reported and underlying profit before tax

Brand perception

In order to manage the HSBC brand most effectively, the Group tracks brand health amongst Personal Financial Services and Commercial Banking customers in each of HSBC's major markets. The survey is conducted on a consistent basis by accredited, independent, third-party organisations. A weighted scorecard of brand measures produces an overall score for each market on a 100-point scale, which is then benchmarked against HSBC's main competitors. The scores from each market are then weighted according to the risk-adjusted revenues in that market to obtain the overall Group score.

In 2008, Personal Financial Services customers judged HSBC's brand to be 9 points stronger than its competitors (+9), up from 6 points in 2007 and above the 8 point target. Commercial Banking customers judged the brand to be 6 points higher than HSBC's competitors (+6), the same as in 2007.

For 2009, HSBC will track brand health in more countries. During 2008, competitors were acquired or withdrew from certain markets, so HSBC re-benchmarked its 2008 performance in respect of both brand and customer satisfaction for Personal Financial Services and Commercial Banking. For 2009, the benchmark is +4 with a target of +5 for the former and, for the latter, the equivalent numbers are +6 and +7, respectively.

Customer satisfaction

Customer recommendation is an important driver of business growth for HSBC. HSBC uses a consistent measure of customer recommendation around the world to continue to improve the services provided by the Group to customers of Personal Financial Services and Commercial Banking. This measurement is carried out by accredited, independent, third-party organisations and the resulting recommendation scores are benchmarked against competitors.

The 2008 customer recommendation target for Personal Financial Services increased from +1 to +2, failing to meet the target of +3 by a small margin. Commercial Banking met the target of +7 over competitors, up from +6 in 2007.

In 2009, HSBC has adopted a new benchmark of +1 and a 2009 target of +3 for Personal Financial Services and a benchmark of +4 and a target of +4 for Commercial Banking.

IT performance and systems reliability

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

Number of customer transactions processed

The number of customer transactions processed reflects the dependency on IT in the delivery channels that customers use to interact with HSBC. Monitoring the volumes by channel enables the Group to allocate resources appropriately. Overall, the results show the desired decrease in staff-assisted transactions. Self-service transactions increased as a result of the redesign of the Group's distribution network and the continuing rollout of One HSBC Technologies, HSBC's project to standardise its primary systems, products and processes. Internet transactions unexpectedly decreased as a direct result of lower online trading volumes in retail securities in

2008. To improve efficiency HSBC aims to manage the rate of increase in IT transaction processing costs to below the volume increase. The following chart shows the 2005 to 2008 volumes per delivery channel:

Number of customer transactions (millions)

Percentage of IT services meeting or exceeding targets

HSBC's IT function establishes with its end-users service levels for systems performance, such as systems running 99.9 per cent of the time or credit card authorisations within two seconds, and monitors the achievement of each of these commitments. The following chart shows the percentage of IT services meeting or exceeding the agreed service targets by region. Overall, the results show a trend of improving service performance.

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Percentage of IT services meeting or exceeding targets

Reconciliation of reported and underlying profit before tax

HSBC measures its performance internally on a like-for-like basis by eliminating the effects of foreign currency translation differences, acquisitions, disposals and gains from the dilution of the Group's interests in associates in 2007, which distort a year-on-year comparison. HSBC refers to this as its underlying performance.

The tables below compare HSBC's underlying performance in 2008 with 2007, and 2007 with 2006. Equivalent tables are provided for each of HSBC's customer groups and geographical segments in their respective sections below.

The foreign currency translation differences were mainly due to the strengthening of the US dollar against sterling in the second half of 2008 and its relative weakness against the euro and the Chinese renminbi in 2008 compared with 2007. The Group's reported profit before tax in 2008 was 62 per cent lower than in 2007, with the effect of the change in foreign currency translation rates making a negligible difference. Comparing 2007 with 2006, the reported profit before tax growth was 10 per

cent, of which 4 per cent was explained by exchange rate movements.

The following acquisitions and disposals, which are listed in chronological order, affected both comparisons:

- the acquisition of HSBC's partner's shares in life insurer, Erisa S.A., and property and casualty insurer, Erisa I.A.R.D. (together renamed HSBC Assurances) in France in March 2007;
- the deemed disposals of the stakes in Ping An Insurance (Group) Company of China, Limited (Ping An Insurance), Bank of Communications Co., Limited (Bank of Communications) and Industrial Bank Co. Limited (Industrial Bank) as a consequence of their share offerings on the domestic A share market in mainland China in the first half of 2007, and of the stakes in Financiera Independencia S.A.B. de C.V. (Financiera Independencia) in Mexico and Vietnam Technological and Commercial Joint Stock Bank (Techcombank) following their share issues;
- the disposal of the Hamilton Insurance Company Limited and Hamilton Life Assurance Company Limited in the UK in October 2007;
- the sale of Wealth and Tax Advisory Services to its management in December 2007;
- the acquisition of the assets, liabilities and operations of The Chinese Bank Co., Ltd. (The Chinese Bank) in Taiwan in March 2008;

- the sale of HSBC's UK merchant acquiring business to a joint venture 49 per cent owned by the Group in June 2008; and
- the disposal of seven French regional banking subsidiaries in July 2008.

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HSBC HOLDINGS PLC

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

Reconciliation of reported and underlying profit before tax /
Financial summary

Reconciliation of reported and underlying profit before tax

2008 compared with 2007

HSBC	2008 compared with 2007							Reported change
	2007 as reported US\$m	2007 acquisitions, disposals & dilution gains ¹ US\$m	Currency translation ² US\$m	2007 at 2008 exchange rates ³ US\$m	2008 acquisitions and disposals ¹ US\$m	Underlying change US\$m	2008 as reported US\$m	
Net interest income	37,795	(389)	(4)	37,402	250	4,911	42,563	1
Net fee income	22,002	(239)	(152)	21,611	18	(1,605)	20,024	(
Other income ⁴	19,196	(1,232)	(329)	17,635	3,148	(1,688)	19,095	(
Net operating income⁵	78,993	(1,860)	(485)	76,648	3,416	1,618	81,682	
Loan impairment charges and other credit risk provisions	(17,242)	31	113	(17,098)	(6)	(7,833)	(24,937)	(4
Net operating income	61,751	(1,829)	(372)	59,550	3,410	(6,215)	56,745	(
Operating expenses (excluding goodwill impairment)	(39,042)	514	301	(38,227)	(198)	(110)	(38,535)	
Goodwill impairment	□	□	□	□	□	(10,564)	(10,564)	n/
Operating profit	22,709	(1,315)	(71)	21,323	3,212	(16,889)	7,646	(6
Income from associates	1,503	(12)	107	1,598	□	63	1,661	1
Profit before tax	24,212	(1,327)	36	22,921	3,212	(16,826)	9,307	(6

2007 compared with 2006

HSBC	2006 as reported US\$m	2006 acquisitions and disposals ¹ US\$m	Currency translation ² US\$m	2006, at 2007 exchange rates ⁶ US\$m	2007		2007 as reported US\$m	Reported change %	Underlying change %
					acquisitions & disposals & dilution gains ¹ US\$m	Underlying change US\$m			
Net interest income	34,486	(3)	1,086	35,569	794	1,432	37,795	10	4
Net fee income	17,182	53	750	17,985	(47)	4,064	22,002	28	23
Other income ⁴	13,698	(53)	733	14,378	1,113	3,705	19,196	40	26
Net operating income ⁵	65,366	(3)	2,569	67,932	1,860	9,201	78,993	21	14
Loan impairment charges and other credit risk provisions	(10,573)	□	(243)	(10,816)	(133)	(6,293)	(17,242)	(63)	(58)
Net operating income	54,793	(3)	2,326	57,116	1,727	2,908	61,751	13	5
Operating expenses	(33,553)	2	(1,536)	(35,087)	(397)	(3,558)	(39,042)	(16)	(10)
Operating profit	21,240	(1)	790	22,029	1,330	(650)	22,709	7	(3)
Income from associates	846	□	20	866	(41)	678	1,503	78	78
Profit before tax	22,086	(1)	810	22,895	1,289	28	24,212	10	□

For footnotes, see page 143.

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Financial summary

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Consolidated financial statements	

The consolidated financial statements of HSBC and the separate financial statements of HSBC Holdings have been prepared in accordance with International Financial Reporting Standards (IFRSs) as issued by the International Accounting Standards Board (IASB) and as endorsed by the European Union (EU). EU-endorsed IFRSs may differ from IFRSs as issued by the IASB if, at any point in time, new or amended IFRSs have not been endorsed by the EU. At 31 December 2008, there were no unendorsed standards effective for the year ended 31 December 2008 affecting these consolidated and separate financial statements, and there was no difference between IFRSs endorsed by the EU and IFRSs issued by the IASB in terms of their application to HSBC. Accordingly, HSBC's financial statements for the year ended 31 December 2008 are prepared in accordance with IFRSs as issued by the IASB.

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

Constant currency

Constant currency comparatives for 2007 and 2006 used in the 2008 and 2007 commentaries, respectively, are computed by retranslating into US dollars, for non-US dollar branches, subsidiaries, joint ventures and associates:

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- the income statements for 2007 and 2006 at the average rates of exchange for 2008 and 2007, respectively; and
- the balance sheets at 31 December 2007 and 2006 at the prevailing rates of exchange on 31 December 2008 and 2007, respectively.

No adjustment has been made to the exchange rates used to translate foreign currency denominated assets and liabilities into the functional currencies of any HSBC branches, subsidiaries, joint ventures or associates. When reference is made to "constant currency" in tables or commentaries, comparative data reported in the functional currencies of HSBC's operations have been translated at the appropriate exchange rates applied in the current period on the basis described above.

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)*Financial summary > Income statement*

Income statement

	2008	2007	2006
	US\$m	US\$m	US\$m
Interest income	91,301	92,359	75,879
Interest expense	(48,738)	(54,564)	(41,393)
Net interest income	42,563	37,795	34,486
Fee income	24,764	26,337	21,080
Fee expense	(4,740)	(4,335)	(3,898)
Net fee income	20,024	22,002	17,182
Trading income excluding net interest income	847	4,458	5,619
Net interest income on trading activities	5,713	5,376	2,603
Net trading income	6,560	9,834	8,222
Changes in fair value of long-term debt issued and related derivatives	6,679	2,812	(35)
Net income/(expense) from other financial instruments designated at fair value	(2,827)	1,271	692
Net income from financial instruments designated at fair value	3,852	4,083	657
Gains less losses from financial investments	197	1,956	969
Gains arising from dilution of interests in associates	□	1,092	□
Dividend income	272	324	340
Net earned insurance premiums	10,850	9,076	5,668
Gains on disposal of French regional banks	2,445	□	□
Other operating income	1,808	1,439	2,546
Total operating income	88,571	87,601	70,070
Net insurance claims incurred and movement in liabilities to policyholders	(6,889)	(8,608)	(4,704)
Net operating income before loan impairment charges and other credit risk provisions	81,682	78,993	65,366
Loan impairment charges and other credit risk provisions	(24,937)	(17,242)	(10,573)
Net operating income	56,745	61,751	54,793
Employee compensation and benefits	(20,792)	(21,334)	(18,500)
General and administrative expenses	(15,260)	(15,294)	(12,823)
Depreciation and impairment of property, plant and equipment	(1,750)	(1,714)	(1,514)
Amortisation and impairment of intangible assets	(733)	(700)	(716)
Goodwill impairment	(10,564)	□	□
Total operating expenses	(49,099)	(39,042)	(33,553)

Operating profit	7,646	22,709	21,240
Share of profit in associates and joint ventures	1,661	1,503	846
Profit before tax	9,307	24,212	22,086
Tax expense	(2,809)	(3,757)	(5,215)
Profit for the year	6,498	20,455	16,871
Profit attributable to shareholders of the parent company	5,728	19,133	15,789
Profit attributable to minority interests	770	1,322	1,082

2008 compared with 2007

Reported pre-tax profits in 2008 fell by 62 per cent to US\$9.3 billion and earnings per share declined to US\$0.47. In a year characterised by a significant deterioration in the credit markets and by unprecedented illiquidity in most asset classes, return on average total shareholders' equity fell to 4.7 per cent.

The fall in profit before tax was exacerbated by recognition of a US\$10.6 billion impairment

charge which wrote off in full the goodwill carried on the balance sheet in respect of the Group's investment in its North America Personal Financial Services business. This non-cash charge arose substantially in the second half of 2008 as heightened risk premia in the market increased discount rates and cash flows estimated from ongoing activities fell as the US economy continued to decline and the outlook for the business deteriorated.

Asian performance was strong, generating profit

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before tax of US\$11.9 billion, broadly in line with results excluding the dilution gains which arose in 2007 when HSBC did not participate in share offerings by its mainland Chinese associates. Within Asia, Global Banking and Markets' results were strongly ahead, driven by foreign exchange, Rates and securities services. Balance Sheet Management revenues rose significantly from positioning ahead of interest rate cuts, and were especially strong in Europe despite losses from the defaults of certain financial sector companies.

With the exception of Personal Financial Services, which incurred significant losses in North America, all customer groups remained profitable. Commercial Banking and Private Banking delivered results broadly in line with 2007, while Global Banking and Markets' profits declined.

Performance was overshadowed by a US\$7.7 billion rise in loan impairment charges and other credit risk provisions, largely from the US consumer finance business, and a further US\$5.4 billion in trading write-downs on illiquid legacy positions in credit trading, leveraged and acquisition finance and monoline credit exposure in Global Banking and Markets. Increases in loan impairment charges and other credit risk provisions in Personal Financial Services and Commercial Banking, the latter rising rapidly in the second half of 2008 from a low base, occurred as the global economy slowed. Global Banking and Markets also experienced a rise in loan impairment charges and other credit risk provisions as refinancing options dried up for a number of companies as the market for long-term asset financing became increasingly illiquid. The market turmoil also led to impairments on equity securities in the available-for-sale portfolio.

The following items were significant:

- the non-recurrence of US\$1.1 billion of gains which arose in 2007 on the dilution of the Group's stakes in various associates;
- a US\$3.9 billion increase (from US\$2.8 billion in 2007 to US\$6.7 billion) in fair value gains from wider credit spreads recorded predominantly on HSBC's own long-term debt designated at fair value. These gains are reported in the "Other" segment, are not allocated to customer groups and are not included within regulatory capital calculations;
- the gain of US\$2.4 billion on the sale of the French regional banks; and
- a charge against trading income of US\$984 million following the alleged fraud in December 2008 relating to Bernard L Madoff Investment Securities LLC ("Madoff Securities").

On an underlying basis, profit before tax declined by 73 per cent compared with 2007. The difference between the reported and underlying results is explained on page 21. Except where stated otherwise, the commentaries in the Financial Summary are on an underlying basis.

2007 compared with 2006

The strength of HSBC's geographically diversified business model was demonstrated by profit growth in a year in which financial markets experienced significant dislocation and the credit environment, particularly in the US, deteriorated markedly. Pre-tax profits in 2007 increased by 10 per cent to US\$24.2 billion and earnings per share rose by 18 per cent to US\$1.65. Despite difficult market conditions, the return on shareholders' equity exceeded 15 per cent, capital ratios remained strong, revenue growth was in double digits and the cost efficiency ratio improved. For the first time in recent years, pre-tax profits from the Group's emerging markets operations exceeded 60 per cent of total profits.

On an underlying basis, profit before tax was broadly in line with 2006.

The Group had a notably strong year in most emerging markets. Vigorous economic activity, strong trade flows and buoyant equity markets helped drive broadly based profit growth, with profits in all customer groups ahead of 2006. A strong performance in Asia in all customer groups compensated for the effect of deteriorating

conditions in the US and slower growth in other mature markets. Commercial Banking and Private Banking again delivered record results, as did many of the businesses within Global Banking and Markets, including foreign exchange, payments and cash management, equities, HSBC Global Asset Management and securities services.

The deterioration in credit quality which began in 2006 in a particular portfolio of purchased mortgages in the US consumer finance business widened in the second half of 2007, leading to significantly increased loan impairment charges in the US as economic conditions deteriorated and global market liquidity for asset-backed securities dried up. This lack of liquidity adversely affected credit trading and asset-backed securities businesses within Global Banking and Markets, where de-leveraging of traded markets contributed to volatility and lower valuations. The effect of these factors was partially offset by a gain on HSBC's own debt designated at fair value.

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HSBC HOLDINGS PLC

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

Financial summary > Group performance > Net interest income / net fee income

Group performance by income and expense item

Net interest income

	2008	2007	2006
Net interest income ¹ (US\$m)	42,563	37,795	34,486
Average interest-earning assets (US\$m)	1,466,622	1,296,701	1,113,404
Gross interest yield ² (per cent)	6.23	7.12	6.82
Net interest spread ³ (per cent)	2.87	2.86	2.94
Net interest margin ⁴ (per cent)	2.90	2.91	3.10

1 Net interest income includes the cost of funding trading assets, while the related external revenues are reported in trading income. In HSBC's customer group results, the cost of funding trading assets is included with Global Banking and Markets' net trading income as an interest expense.

2 Gross interest yield is the average annualised interest rate earned on average interest-earning assets (AIEA).

3 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.

4 Net interest margin is net interest income expressed as an annualised percentage of AIEA.

2008 compared with 2007

Reported net interest income of US\$42.6 billion rose by 13 per cent compared with 2007, 13 per cent on an underlying basis.

Growth in net interest income was driven by significantly higher revenues in Balance Sheet Management, in part reflecting favourable positioning to take advantage of falling interest rates. Lending and deposit balances also grew strongly, while progressive reductions in central bank reference rates led to a decline in both asset yields and the cost of funds. Overall, spreads narrowed on an underlying basis.

Average interest-earning assets increased to US\$1,467 billion, led by growth in average loans and advances to customers. This was mainly due to an increase in average term lending balances in Europe and Asia.

An increase in average interest-bearing liabilities was driven by growth in average customer accounts, notably in Europe. HSBC attracted substantial deposits from customers who valued HSBC's perceived strength at a time of global financial market turmoil and customers also expressed a preference for security and liquidity following declines in equity markets.

Interest rates were cut aggressively in many countries during 2008, as central banks reduced their reference rates as part of stimulus programmes introduced in response to deteriorating economic conditions. This contributed to a decline in asset yields. The cost of funds also fell, but this was less significant than the decline in

yields as spreads narrowed overall on an underlying basis.

In North America, net interest income was also adversely affected by rises in loan modifications designed to reduce the payment burden on the Group's customers, and impaired loans.

2007 compared with 2006

Reported net interest income increased by 10 per cent to US\$37.8 billion, 4 per cent on an underlying basis. The increase was driven by an underlying 10 per cent rise in average interest earning assets to US\$1,297 billion, partly offset by a decline in spreads as funding costs rose more than yields.

The growth in average interest earning assets was due to a 6 per cent rise in average loans and advances to customers. HSBC continued to focus on competitive liability products, with average deposits and current account balances rising by 16 per cent, driven by customer acquisition in Rest of Asia-Pacific and deposit balance growth in North America, Europe and Hong Kong.

Balance Sheet Management revenues increased compared with 2006, particularly in Hong Kong and Rest of Asia-Pacific as deposits grew strongly.

Lending spreads in 2007 reflected the continued benign corporate and commercial credit conditions that have existed in the last three or four years. However, some upward re-pricing occurred in personal lending as a result of growing delinquency and restricted credit appetite and, as market liquidity diminished in the last four months of 2007, the value and cost of funds, including the cost of funding HSBC's trading activities, rose markedly.

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Net fee income

	2008	2007	2006
	US\$m	US\$m	US\$m
Cards	5,844	6,496	5,367
Account services	4,353	4,359	3,633
Funds under management	2,757	2,975	2,718
Insurance	1,771	1,836	1,358
Broking income	1,738	2,012	1,354
Credit facilities	1,313	1,138	922
Global custody	1,311	1,404	797
Imports/exports	1,014	866	780
Remittances	610	556	472
Unit trusts	502	875	520
Corporate finance	381	409	255
Underwriting	325	367	286
Trust income	325	299	248
Taxpayer financial services	168	252	263
Maintenance income on operating leases	130	139	122
Mortgage servicing	120	109	97
Other	2,102	2,245	1,888
	24,764	26,337	21,080
Less: fee expense	(4,740)	(4,335)	(3,898)
Net fee income	20,024	22,002	17,182

2008 compared with 2007

Reported net fee income declined by 9 per cent to US\$20 billion, 7 per cent lower on an underlying basis.

Lower equity market-related revenues, notably in Hong Kong, were driven by weakened investor sentiment, and reflected in the fall of 17 per cent in the aggregate of broking income, global custody and unit trust income. Similarly, fund management fees declined as equity markets retreated and lower performance fees were earned.

HSBC announced revisions to its credit card fee charging policies in the US in 2007, and this fed through as expected in the form of a substantial decline in overlimit fees, further compounded by lower cash advance and interchange fee income as a result of reduced volumes. In the UK, the divestment in 2008 of the card acquiring business resulted in reduced card acquiring fees. Offsetting these factors were rises in card fees in Hong Kong, the Middle East, India and Turkey.

Fee income from credit facilities rose, notably in the Middle East, in line with customer volumes. Growth in fee income from trade and supply chain products reflected higher volumes and customer acquisition in India and, to a greater extent in the Middle East, increased activity driven by commodity price inflation.

2007 compared with 2006

Reported net fee income increased by 28 per cent to US\$22 billion, 23 per cent on an underlying basis.

The rise in card fee income was mainly in the US and Mexico. Income growth in the US was driven by higher late and over-limit fees in addition to higher balances. Revenue from enhancement services on cards also increased. In Mexico, the credit card business continued to grow, both in balances and in transaction volumes.

Higher income from funds under management products, broking services, unit trusts and global custody was driven by buoyant stock markets in Hong Kong and throughout the Rest of Asia-Pacific region, enhanced by the launch of new investment schemes.

Increased account services income was due to higher levels of customer activity in Europe, North America and Latin America. In the US, growth in credit card balances triggered an increased use of the Intellicheck service. In the UK, growth in the sale of fee-based packaged accounts contributed to a rise in account services fees.

An increase in insurance fees was driven by higher life insurance commission income, boosted by new product offerings in Hong Kong.

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HSBC HOLDINGS PLC

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

Financial summary > Group performance > Net trading income / Net income from financial instruments at FV

Net trading income

	2008	2007	2006
	US\$m	US\$m	US\$m
Trading activities	2,988	4,521	5,465
Net interest income on trading activities	5,713	5,376	2,603
Other trading income \square hedge ineffectiveness:			
\square on cash flow hedges	(40)	(77)	(122)
\square on fair value hedges	5	19	16
Non-qualifying hedges	(1,122)	(5)	260
Losses on collapse of Madoff Securities	(984)	\square	\square
	<hr/>	<hr/>	<hr/>
Net trading income ^{1,2}	6,560	9,834	8,222
	<hr/>	<hr/>	<hr/>

1 The cost of internal funding of trading assets was US\$5,547 million (2007: US\$5,433 million; 2006: US\$2,658 million) and is excluded from the reported \square Net trading income \square line and included in \square Net interest income \square . However, this cost is reinstated in \square Net trading income \square in HSBC's customer group and global business reporting.

2 Net trading income includes US\$529 million (2007: US\$34 million), associated with changes in the fair value of issued structured notes and other hybrid instrument liabilities derived from movements in HSBC issuance spreads.

2008 compared with 2007

Reported net trading income fell by 33 per cent to US\$6.6 billion, 32 per cent lower on an underlying basis.

Net income from trading activities declined by 81 per cent, driven by the continuing effect of the market turmoil which led to US\$5.4 billion of write-downs on legacy monoline credit exposures, credit trading and leveraged and acquisition finance loans. More information about the losses, the associated assets and residual exposure is provided in \square Impact of Market Turmoil \square on pages 144 to 162.

Record foreign exchange trading income was due to increased customer volumes and market volatility across all regions, as investors sought to reduce risk in the second half of 2008, driving growth in global foreign exchange trading as demand for assets denominated in US dollars and Japanese Yen increased.

Rates trading income rose substantially, with record revenues in the first half of 2008 due to favourable positioning against movements in interest rate yield curves as central banks responded to the market turmoil by lowering short-term interest rates. Revenues were also boosted by an increased number of deals, widening spreads and increased customer demand for trading and hedging products.

The decline in equities trading income reflected weaker equity markets, particularly in Hong Kong, where demand for structured equity products fell. In addition, following the alleged fraud at Madoff Securities, HSBC wrote off the value of units it held in funds that had invested with the company and took a US\$984 million charge.

The units had been acquired in connection with various financing transactions HSBC had entered into with institutional clients.

The decline in non-qualifying hedges related to mark-to-market losses on cross-currency swaps as the US dollar appreciated and on interest rate swaps as interest rates fell in late 2008.

Widening credit spreads led to further gains on credit default swap transactions in parts of the Global Banking portfolio.

2007 compared with 2006

Reported net trading income increased by 20 per cent to US\$9.8 billion, 13 per cent on an underlying basis.

Net interest income on trading activities more than doubled, mainly due to increased holdings of shorter maturity assets in the UK.

Net trading income was significantly affected by a total of US\$2.1 billion of write-downs on credit trading, leveraged and acquisition financing positions, and monoline credit exposures, resulting from deterioration in the credit market in the second half of 2007. The write-downs arose mainly in the US and, to a lesser extent, the UK.

Income from foreign exchange trading increased by 40 per cent to a record result. Revenues were driven by higher customer volumes, against the backdrop of a weakening US dollar and greater market volatility.

Trading income from structured derivatives fell by 26 per cent. The structured credit business incurred losses in the second half of the year in the difficult trading conditions. This was partly offset by higher trading income from other structured derivative products, following investment made in technical expertise and systems in previous years.

Record results were achieved in the equities business, reflecting strong growth across all regions, particularly Europe.

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Net income from financial instruments designated at fair value

	2008	2007	2006
	US\$m	US\$m	US\$m
Net income arising from:			
□ financial assets held to meet liabilities under insurance and investment contracts	(5,064)	2,056	1,552
□ liabilities to customers under investment contracts	1,751	(940)	(1,008)
□ HSBC's long-term debt issued and related derivatives	6,679	2,812	(35)
□ change in own credit spread on long-term debt	6,570	3,055	(388)
□ other changes in fair value	109	(243)	353
□ other instruments designated at fair value and related derivatives	486	155	148
Net income from financial instruments designated at fair value	3,852	4,083	657
Financial assets designated at fair value at 31 December	28,533	41,564	20,573
Financial liabilities designated at fair value at 31 December	74,587	89,939	70,211

1 *Includes gains and losses arising from changes in the fair value of derivatives that are managed in conjunction with HSBC's long-term debt issued.*

HSBC designates certain financial instruments at fair value to remove or reduce accounting mismatches in measurement or recognition, or where financial instruments are managed and their performance is evaluated together on a fair value basis. All income and expense from financial instruments designated at fair value are included in this line except for interest arising from HSBC's issued debt securities and related derivatives managed in conjunction with those debt securities, which is recognised in □Interest expense□.

HSBC principally uses the fair value designation in the following instances:

- for certain fixed-rate long-term debt issues whose rate profile has been changed to floating through interest rate swaps as part of a documented interest rate management strategy. Approximately US\$59 billion (2007: US\$66 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 widen or narrow, accounting profits or losses are booked, respectively. The size and direction of the accounting consequences of changes in own credit spread and ineffectiveness can be volatile from year to year, but do not alter the cash flows envisaged as part of the documented interest rate management strategy; as a consequence of this, gains and losses arising from changes in own credit spread on long-term debt are not regarded internally as part of managerial performance. Similarly, such gains and losses are ignored in the calculation of regulatory capital.

- for approximately US\$11 billion (2007: US\$17 billion) of financial assets held to meet liabilities under insurance contracts, and certain liabilities under investment contracts with discretionary participation features; and
- for approximately US\$7 billion (2007: US\$14 billion) of financial assets held to meet liabilities under unit-linked and other investment contracts.

2008 compared with 2007

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Reported net income from financial instruments designated at fair value decreased by US\$231 million to US\$3.9 billion in 2008.

Credit spreads widened significantly during the year, leading to US\$6.6 billion of positive fair value movements on certain long-term debt issued by the Group, compared with US\$3.1 billion in 2007. These fair value movements will fully reverse over the life of the debt. The cumulative fair value adjustment at 31 December 2008 amounted to US\$8.0 billion.

A negative movement of US\$5.1 billion was recorded in the fair value of assets held to back insurance and investment contracts, compared with a positive movement of US\$2.1 billion in 2007. This reflected investment losses driven by falling equity and bond markets, predominantly affecting the value of assets held in unit-linked and participating funds in Hong Kong, France and the UK. The negative movement in fair value is partially offset by a corresponding reduction in [Net insurance claims and movement in liabilities to policyholders], where unit-linked policyholders in particular participate in the investment performance experienced on the investment portfolios held to support the liabilities.

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HSBC HOLDINGS PLC

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

Financial summary > Group performance > Gains less losses from financial investments / Dilution gains / Net earned insurance premiums

For assets held to meet liabilities under investment contracts the corresponding reduction in the liability to customers is also reported within net income from financial instruments designated at fair value. A reduction of US\$1.8 billion in the movement in fair value of liabilities held under investment contracts compared with an increase in the fair value of liabilities of US\$940 million in 2007.

2007 compared with 2006

Credit spreads widened significantly in the second half of 2007, leading to a substantial increase in net income from financial instruments designated at fair value compared with 2006. This was primarily driven by a widening in credit spreads on certain fixed-rate long-term debt issued by HSBC Holdings

and its subsidiaries. These cumulative gains will fully reverse over the life of the debt. The cumulative adjustments to reserves (when the policy is applied for the first time) and the income statement (subsequent applications of the policy), reflecting the change in own credit spread since the fair value option was available, was US\$1.6 billion after taking into account the US\$3.1 billion credit in 2007.

Income from assets held to meet liabilities under insurance and investment contracts also rose, by 32 per cent, reflecting primarily premium growth and higher investment returns on the portfolios held by the insurance businesses in the UK and Hong Kong. The change in fair value of liabilities under investment contracts declined by 7 per cent.

Gains less losses from financial investments

	2008	2007	2006
	US\$m	US\$m	US\$m
Net gain from disposal of:			
□ debt securities	19	120	252
□ equity securities	1,216	1,864	702
□ other financial investments	4	14	15
	1,239	1,998	969
Impairment of available-for-sale equity securities	(1,042)	(42)	□
Gains less losses from financial investments	197	1,956	969

2008 compared 2007

Reported gains less losses of US\$197 million from financial investments during 2008 were 90 per cent lower than in 2007, 93 per cent lower on an underlying basis. A reduction in net gains from disposals was compounded by significant impairments recognised on equity securities held in the available-for-sale portfolio as certain investments were marked down to reflect the prevailing market conditions.

The redemption of Visa Inc. (□Visa□) shares following its IPO resulted in significant gains, and there were further gains from the sale of MasterCard Inc. (□MasterCard□) shares. These were more than offset by losses in Principal Investments and the non-recurrence of various significant gains in 2007, mostly in respect of Euronext, the European stock exchange, and a credit bureau in Brazil.

Declining equity markets caused impairments to be recognised against a number of strategic investments in Asia, held in the available-for-sale portfolio and on private equity investments, mainly in Europe. The market turmoil in the US also led to impairments against investments in various US financial institutions.

2007 compared with 2006

Net gains of US\$2.0 billion were reported by HSBC as a result of the disposal of financial investments during 2007, a two-fold increase over 2006 and 93 per cent higher on an underlying basis.

The increase was driven by the sale of shares and various equity investments in all regions, including holdings in Euronext (the European stock exchange), MasterCard in North America and a credit bureau in Brazil. In Private Banking, a gain of US\$91 million arose from the sale of a further holding in the Hermitage Fund, compared with US\$117 million in 2006. The gains in 2007 were marginally offset by the non-recurrence of a US\$101 million gain on the sale of part of HSBC's stake in UTI Bank Limited in 2006.

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Gains arising from dilution of interests in associates

In 2007, HSBC's associates, Industrial Bank, Ping An Insurance and Bank of Communications in mainland China, Financiera Independencia in Mexico and Techcombank in Vietnam issued new shares for which HSBC did not subscribe. As a

Net earned insurance premiums

consequence of the new monies raised by the associates, HSBC's share of their underlying assets increased by US\$1.1 billion, notwithstanding the reduction in the Group's interests. These gains were presented in the income statement as "Gains arising from dilution of interests in associates", and should be regarded as exceptional.

	2008	2007	2006
	US\$m	US\$m	US\$m
Gross insurance premium income	12,547	11,001	6,455
Reinsurance premiums	(1,697)	(1,925)	(787)
Net earned insurance premiums	10,850	9,076	5,668

2008 compared with 2007

Reported net earned insurance premiums amounted to US\$10.9 billion, 20 per cent higher than in 2007. HSBC acquired the remaining interest in HSBC Assurances in France in March 2007 and, in October 2007, sold the Hamilton Insurance Company Limited and Hamilton Life Assurance Company Limited in the UK. On an underlying basis, net earned insurance premiums increased by 14 per cent.

Growth in net earned insurance premiums was driven by a continued strong performance from the UK life assurance business, mainly as a result of higher sales of the Guaranteed Income Bond, a non-linked product that was launched in June 2007. The introduction of enhanced life assurance benefits to certain pension products, which led to these products being reclassified as insurance contracts, also resulted in higher premiums.

The Hong Kong insurance business also performed well with respect to premium growth, due to stronger sales of products with discretionary participation features ("DPF") and an increase in regular premiums partly offset by a reduction in unit-linked premiums.

In France, HSBC Assurances performed well in a declining market, as three promotional campaigns during the year contributed to growth in sales of policies with DPF. However, a significant one-off reinsurance transaction undertaken during 2008 caused net earned insurance premiums to decrease compared with 2007.

2007 compared with 2006

Reported net earned insurance premiums of US\$9.1 billion were 60 per cent higher than in 2006, boosted by HSBC's acquisition in the first half of 2007 of the remaining shares in HSBC Assurances in France and the purchase of HSBC Bank Panama in Central America in late 2006. Underlying net insurance premiums grew by 21 per cent.

Growth in net earned insurance premiums was achieved in all regions except North America, primarily from new business growth in the life insurance business in Europe, Hong Kong and Latin America. An increase in net earned premiums was recorded in the UK due to higher sales of Guaranteed Income Bonds and the introduction of enhanced death benefits to pension contracts. New product launches also aided growth in Hong Kong. In Latin America, higher premiums in Brazil were driven by increased sales of pension products with linked-life policies.

In non-life insurance, the UK benefited from a decision to reduce the proportion of risk and corresponding premiums ceded to reinsurers compared with 2006. The Latin American business also performed well, led by growth in motor premiums in Argentina. However, results in North America declined, as a reduction in loan volumes led to a fall in credit insurance sales and HSBC stopped reinsuring credit insurance for other lenders.

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)*Financial summary > Group performance > Other operating income / Net insurance claims incurred*

Other operating income

	2008	2007	2006
	US\$m	US\$m	US\$m
Rent received	606	630	687
Gains/(losses) recognised on assets held for sale	(130)	5	28
Valuation gains/(losses) on investment properties	(92)	152	164
Gain on disposal of property, plant and equipment, intangible assets and non-financial investments	465	213	781
Change in present value of in-force long-term insurance business	286	(145)	40
Gain on repurchase of 8 Canada Square	416	□	□
Other	257	584	846
	<hr/>	<hr/>	<hr/>
Other operating income	1,808	1,439	2,546
	<hr/>	<hr/>	<hr/>

2008 compared with 2007

Reported other operating income of US\$1.8 billion was 26 per cent higher than in 2007. This included gains of US\$425 million on the sale of the card merchant acquiring business in the UK and US\$71 million on the sale of HSBC's entire stake in Financiera Independencia, a Mexican consumer lending company. On an underlying basis, other operating income fell by 23 per cent.

The difficult property market conditions in the UK led to a loss in value of a property fund, lower income from the sale of property fund assets and a reduction in Group real estate disposals in 2008. Similarly, in Hong Kong revaluation gains on investment properties did not recur.

Life assurance enhancements to pension products resulted in increased present value of in-force long-term insurance (□PVI□) business, which also benefited from the non-recurrence of regulatory changes in 2007 in the UK.

During 2008, HSBC recognised a gain of US\$416 million in respect of the purchase of the subsidiary of Metrovacesa which owned the property and long leasehold comprising 8 Canada Square, London. See Note 23 on the Financial Statements.

Other operating income declined, driven by losses on sale of the Canadian vehicle finance business and other loan portfolios in 2008, in addition to the non-recurrence of gains on disposal of fixed assets and private equity investments in 2007.

2007 compared with 2006

Reported other operating income of US\$1.4 billion was 43 per cent lower than in 2006, 51 per cent lower on an underlying basis.

Significant decreases in gain on disposal of property and other income were driven by lower proceeds from the sale of real estate in the declining US property market. This was compounded by the non-recurrence of income earned on asset disposals in 2006, including the sale of the former head office building of Hang Seng Bank in Hong Kong and properties in Japan and India, and the transfer of the credit card acquiring business into a joint venture with Global Payments Inc. A gain on the sale and leaseback of a London building in 2007 and the non-recurrence of a loss on sale on asset disposals in 2006 partially offset these factors.

Although HSBC sold its Canary Wharf headquarters building at 8 Canada Square in 2007, the gain remained unrecognised as the Group continued to provide bridge finance for the debt portion of the transaction.

PVIF business declined, primarily due to a change in the calculation methodology employed in the UK as HSBC implemented regulatory changes to the rules governing the calculation of insurance liabilities. This had a marginally positive effect on profit as there was a corresponding reduction in policyholder liabilities. Income rose in Mexico due to a refinement of the income recognition methodology in respect of long-term insurance contracts.

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Net insurance claims incurred and movement in liabilities to policyholders

	2008	2007	2006
	US\$m	US\$m	US\$m
Insurance claims incurred and movement in liabilities to policyholders:			
□ gross	9,206	9,550	5,072
□ reinsurers' share	(2,317)	(942)	(368)
	6,889	8,608	4,704
□ net	6,889	8,608	4,704

1 Net insurance claims incurred and movement in liabilities to policyholders arise from both life and non-life insurance business. For non-life business, amounts reported represent the cost of claims paid during the year and the estimated cost of notified claims. For life business, the main element of claims is the liability to policyholders created on the initial underwriting of the policy and any subsequent movement in the liability that arises, primarily from the attribution of investment performance to savings-related policies. Consequently, claims rise in line with increases in sales of savings-related business and with investment market growth.

2008 compared with 2007

Reported net insurance claims incurred and movement in liabilities to policyholders decreased by 20 per cent to US\$6.9 billion. HSBC acquired the remaining interest in HSBC Assurances in France in March 2007 and, in October 2007, sold the Hamilton Insurance Company Limited and Hamilton Life Assurance Company Limited in the UK. On an underlying basis, net insurance claims incurred and movement in liabilities to policyholders fell by 22 per cent.

The reduction in net insurance claims incurred and movement in liabilities to policyholders primarily reflected the impact of markedly weaker investment markets worldwide. This led to a reduction in liabilities to policyholders on unit-linked and, to a certain extent, participating policies where policyholders participate in the investment performance of the assets supporting the liabilities. As noted above, the losses experienced on the assets held to support insurance contract liabilities are reported in □Net income from financial instruments designated at fair value□.

The decline arising from market value movements was partially offset by an increase in claims incurred and movement in liabilities to policyholders driven by new business growth, most significantly in France, the UK and Hong Kong. In addition, 2007 was affected by the implementation of an FSA regulatory change, which led to lower gross liability valuations in that year, along with a reduction in the corresponding reinsurers' share.

A significant increase in the reinsurers' share of claims incurred and movement in liabilities to policyholders was primarily driven by the above regulatory change plus an increase in a reserve provision on a unit-linked product in Hong Kong, which was fully reinsured. In addition, a significant one-off reinsurance transaction was undertaken in France during 2008.

2007 compared with 2006

Reported net insurance claims incurred and movement in liabilities to policyholders of US\$8.6 billion were 83 per cent higher than in 2006 following the acquisition of the remaining shares in HSBC Assurances in France in March 2007 and HSBC Bank Panama in late 2006. The increase was 32 per cent on an underlying basis.

Growth in net insurance claims incurred and movement in liabilities to policyholders was largely driven by the life insurance business. This reflected a combination of business growth, and was in line with higher net earned insurance premiums and, where policyholders participate in the investment performance of the assets supporting the liabilities, higher investment returns on unit-linked and participating policies. This was most notable in Hong Kong, the UK and Brazil. There was an offsetting increase in □Net income from financial instruments designated at fair value□ which reflected these investment returns. In addition, FSA rule changes in the UK led to a lower valuation of the liabilities to policyholders on life policies.

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)*Financial summary > Group performance > Loan impairment charges*

Loan impairment charges and other credit risk provisions

	2008 US\$m	2007 US\$m	2006 US\$m
Loan impairment charges			
New allowances net of allowance releases	24,965	18,182	11,326
Recoveries of amounts previously written off	(834)	(1,005)	(779)
	24,131	17,177	10,547
Individually assessed allowances	2,064	796	458
Collectively assessed allowances	22,067	16,381	10,089
Impairment of available-for-sale debt securities	737	44	21
Other credit risk provisions	69	21	5
Loan impairment charges and other credit risk provisions	24,937	17,242	10,573
	%	%	%
As a percentage of net operating income before loan impairment charges and other credit risk provisions	30.5	21.8	16.2
Impairment charges on loans and advances to customers as a percentage of gross average loans and advances to customers	2.5	2.0	1.4
	US\$m	US\$m	US\$m
Customer impaired loans	25,352	19,582	15,071
Customer loan impairment allowances	23,909	19,205	13,578

2008 compared with 2007

Reported loan impairment charges and other credit risk provisions were US\$24.9 billion in 2008, an increase of 45 per cent over 2007, 46 per cent on an underlying basis.

A deterioration in credit quality was experienced across all customer groups and geographical regions as the global economy slowed. The rise in Group loan impairment charges and other credit risk provisions also reflected an underlying 8 per cent increase in lending to customers (excluding the financial sector and settlement accounts).

Loan impairment charges rose significantly in the US by 38 per cent to US\$16.3 billion, due to credit quality deterioration across all US portfolios in Personal Financial Services.

In the US consumer lending portfolio, loan impairment charges rose as delinquency rates deteriorated sharply and the economy declined markedly in the second half of 2008, most notably in the first lien portfolio. This was

particularly apparent in the geographical regions most affected by house price depreciation and rising unemployment rates. In mortgage services, loan impairment charges rose as 2005 and 2006 vintages matured and moved into the later stages of delinquency. This was partly offset by the benefit of lower balances as run-off continued, albeit at a slowing pace as house price depreciation restricted refinancing options for customers. In HSBC USA, loan impairment charges rose as credit quality worsened across the real estate secured portfolio and private label cards. Delinquencies rose

in the prime first lien residential mortgage portfolio, Home Equity Line of Credit and Home Equity Loan second lien portfolios. The higher delinquency rate for prime first lien mortgages was in part due to lower balances following US\$7.0 billion of portfolio sales during the year.

Loan impairment charges in the US card and retail services portfolios rose, again driven by increasing unemployment, portfolio seasoning, higher levels of personal bankruptcy filings and continued weakness in the US economy which was most apparent in regions with the most significant declines in house prices and rising unemployment.

Loan impairment charges in Commercial Banking in North America more than doubled from a low base in 2007, due to deterioration across the commercial real estate, middle market and corporate banking portfolios in the US and, to a lesser extent, higher loan impairment charges against firms in the manufacturing, export and commercial real estate sectors in Canada.

In the UK, a modest decline in loan impairment charges in Personal Financial Services reflected the non-recurrence of a methodology change at HFC in 2007 which resulted in higher impairment charges. Credit quality in the Personal Financial Services portfolio remained broadly stable, reflecting early risk mitigation through the tightening of lending controls and the sale of non-core credit card portfolios during the year. Credit quality in the unsecured portfolios deteriorated slightly in 2008, particularly in the second half of the year, due to the weakening UK economy. Loan impairment charges in the commercial portfolio rose in 2008 as the

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weakening property market led to higher impairment charges against construction companies and businesses dependent upon the real estate sector, particularly in the final quarter of the year. Impairment charges against banks rose due to some exposure to the Icelandic banks in 2008. In addition, rising levels of personal indebtedness resulted in lower releases and recoveries of charges than in 2007.

Higher loan impairment and other credit risk provisions within Global Banking and Markets in Europe reflected increased charges against certain corporate accounts and impairment recorded on available-for-sale debt securities.

In Mexico, loan impairment charges rose by US\$513 million or 69 per cent, primarily in the credit card portfolio. This was due to a combination of higher lending volumes from organic expansion and higher delinquency rates which were driven by a deterioration in credit quality as the portfolio continued to season and move into the later stages of delinquency. Management took action to enhance collection activity and improve the quality of new business. Impairment charges in the commercial portfolio also rose due to credit quality deterioration among small and medium-sized enterprises as the economy weakened.

In Hong Kong, the rise in loan impairment charges was driven by weakness in parts of the export sector within the commercial portfolio in the second half of 2008. In Global Banking and Markets, credit impairment charges within Balance Sheet Management principally reflected losses on debt securities and paper issued by financial institutions previously rated at investment grade which failed in the year.

In Rest of Asia-Pacific, the growth in loan impairment charges reflected a combination of the expansion of consumer lending and credit quality deterioration in India and the Middle East. In addition, higher impairment charges in Commercial Banking were driven by a deterioration in credit quality in the second half of the year.

For the Group as a whole, the aggregate outstanding customer loan impairment allowances at 31 December 2008 of US\$23.9 billion represented 2.6 per cent of gross customer advances (net of reverse repos and settlement accounts), compared with 2.0 per cent at the end of 2007.

2007 compared with 2006

Reported loan impairment charges and other credit risk provisions were US\$17.2 billion, a 63 per cent increase over 2006.

Loan impairment charges increased by 58 per cent, reflecting substantially higher losses in the US consumer finance loan book, primarily in mortgage lending, but also in the credit cards portfolio in the final part of the year. US delinquency rates increased during 2007 as falling house prices constrained customers' ability to refinance their loans.

The rise in Group charges also reflected an underlying 7 per cent increase in lending to customers (excluding lending to the financial sector and settlement accounts).

In North America, loan impairment charges increased by 79 per cent to US\$12.2 billion. The main factor driving this deterioration was the impact of the weaker housing market on both economic activity and the ability of borrowers to extend or refinance debt. In addition, seasoning and mix change within the credit cards portfolio, and increases in bankruptcy filings after the exceptionally low levels seen in 2006 following changes in legislation, added to loan impairment charges.

The real estate secured portfolios experienced continuing deterioration in credit quality as a lack of demand for securitised sub-prime mortgages and falls in house prices severely restricted refinancing options for many customers. Loan impairment charges rose by 41 per cent to US\$3.1 billion and by 139 per cent to US\$4.1 billion in the mortgage services business and in consumer lending, respectively. Delinquency rates exceeded recent historical trends, particularly for those loans originated in 2005 and 2006. Performance was weakest in housing markets which had previously experienced the steepest home price appreciation, as well as in second lien products and stated income products.

US card services experienced an increase in loan impairment charges from a combination of growth in balances, higher losses in the final part of the year as the economy slowed, a rise in bankruptcy rates to near historical levels, and a shift in portfolio mix to higher levels of non-prime loans.

In the UK, loan impairment charges rose, primarily in the consumer finance business. Delinquency rates on mortgages in the UK offered through HSBC Finance remained stable throughout 2007, with delinquency rates for loans offered in 2006 and 2007 lower than in the preceding two

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)*Financial summary > Group performance > Operating expenses*

years. In the rest of the UK business, loan impairment charges in the second half of 2007 were lower than in the first half of the year, as overall credit quality improved following measures taken to tighten underwriting standards and improve the credit quality of new business. Although losses from mortgage lending remained low, maximum loan to value ratios were reduced during the year to mitigate the effects of a possible housing market downturn.

In Mexico, higher loan impairment charges were driven by strong growth in loan balances, a deterioration in credit quality and portfolio seasoning.

For the Group as a whole, the aggregate outstanding customer loan impairment allowances at 31 December 2007 of US\$19.2 billion represented 2.0 per cent of gross customer advances (net of reverse repos and settlement accounts), compared with 1.6 per cent at the end of 2006.

Impaired loans to customers were US\$18.3 billion at 31 December 2007 compared with US\$13.8 billion at 31 December 2006. On a constant currency basis, impaired loans to customers were 28 per cent higher than in 2006 compared with customer lending growth (excluding loans to the financial sector and settlement accounts) of 7 per cent.

Operating expenses

	2008	2007	2006
	US\$m	US\$m	US\$m
By expense category			
Employee compensation and benefits ¹	20,792	21,334	18,500
Premises and equipment (excluding depreciation and impairment)	4,305	3,966	3,389
General and administrative expenses	10,955	11,328	9,434
Administrative expenses	36,052	36,628	31,323
Depreciation and impairment of property, plant and equipment	1,750	1,714	1,514
Amortisation and impairment of intangible assets	733	700	716
Goodwill impairment	10,564	□	□
Total operating expenses	49,099	39,042	33,553

At 31 December

	2008	2007	2006
Staff numbers (full-time equivalent)			
Europe	82,093	82,166	78,311

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Hong Kong	29,330	27,655	27,586
Rest of Asia-Pacific	98,159	88,573	72,265
North America	44,725	52,722	55,642
Latin America	58,559	64,404	64,900
	<u> </u>	<u> </u>	<u> </u>
Total staff numbers	312,866	315,520	298,704
	<u> </u>	<u> </u>	<u> </u>

1 A charge of US\$135 million was realised in 2006 arising from the waiver of the TSR-related performance condition in respect of the 2003 awards under the HSBC Holdings Group Share Option Plan.

2008 compared with 2007

Reported operating expenses increased by US\$10.1 billion to US\$49.1 billion, due to an impairment charge of US\$10.6 billion to fully write off goodwill in Personal Financial Services in North America. Excluding this, operating expenses remained broadly in line on both reported and underlying bases.

Employee compensation and benefits fell marginally. Lower discretionary bonuses reflected weaker performance in the current economic conditions. A review of actuarial assumptions on employees' defined benefit pensions resulted in lower service costs in the UK. The restructuring of the consumer finance business in North America led to reduced headcount and lower costs. This was partially offset by higher salaries and increased

headcount to support business expansion, mainly in Asia. Restructuring costs were incurred primarily in Latin America and Europe.

Premises and equipment costs increased primarily in the UK and the Rest of Asia-Pacific region, driven by investment in technology and extensions and improvements to the branch and ATM networks. As a consequence, repairs and maintenance costs rose. Commercial property rental costs also increased as a result of higher prices, new rentals and sale and leaseback deals.

General and administrative expenses decreased, primarily due to a one-off recovery of US\$110 million of previous years' transactional taxes in Brazil and the non-recurrence of a number of one-off items in 2007, most notably (i) ex-gratia payments made in the UK in respect of overdraft

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fees, (ii) the provision for reimbursement of certain charges on historic will trusts and other related services in the UK, (iii) the indemnification agreement with Visa ahead of Visa's IPO, and (iv) restructuring charges in the US consumer finance business incurred in 2007. These were partly offset by an increase in the Financial Services compensation scheme levy in the UK and an increase in a litigation provision in Asia.

Goodwill impairment amounting to US\$10.6 billion was booked following the continued deterioration in economic and credit conditions in North America. For further information see Note 22 on the Financial Statements.

2007 compared with 2006

Reported operating expenses increased by US\$5.5 billion to US\$39.0 billion. On an underlying basis, cost growth was 10 per cent.

Employee compensation and benefits rose due to increased headcount employed to support business expansion in Rest of Asia-Pacific and Europe and higher salaries and bonuses. Salary increases reflected inflationary pressures and performance as bonuses rose in response to revenue growth. A change in actuarial assumptions regarding the staff defined benefit pension scheme in the UK led to increased costs. Staff numbers in North America fell as the consumer finance business was restructured, resulting in the discontinuation of certain business channels in mortgage services and the closing of branch offices in consumer lending.

Premises and equipment costs increased on investments in technology, straight-through

processing and extending and improving the branch and ATM networks. In particular, there was investment in the distribution platform in Latin America, Middle East, India and mainland China. The retail bank branch network in North America was extended both within and beyond the Group's traditional spheres of operation to support the expansion of retail and Commercial Banking businesses, increasing premises and equipment costs as a consequence. Commercial property rental costs rose in Hong Kong's dynamic economy, the effect magnified by a sale and leaseback agreement on a headquarters building in 2006. In France, the IT systems inherited with the acquisition of HSBC France were replaced with HSBC's universal banking platform.

General and administrative expenses rose in support of the business expansion and a number of one-off costs. Higher transaction volumes drove processing costs and transactional taxes while business expansion was supported by marketing expenditure. In the UK, ex-gratia payments of US\$227 million were expensed in respect of overdraft fees applied in previous years and a provision of US\$169 million was raised for reimbursement of certain charges on historic will trusts and other related services. In the US, the business incurred US\$70 million of one-off costs arising from the indemnification agreement with Visa ahead of its planned IPO. The US consumer finance business incurred restructuring charges of US\$103 million resulting from the discontinuation of the wholesale and correspondent channels in mortgage services and the closing of branch offices in consumer lending.

Cost efficiency ratios

	2008	2007	2006
	%	%	%
HSBC	60.1	49.4	51.3
Personal Financial Services	76.4	50.3	49.7
Europe	62.7	64.8	59.2
Hong Kong	32.2	27.2	32.2

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Rest of Asia-Pacific	73.5	73.9	71.1
North America	106.8	42.3	42.3
Latin America	59.7	61.3	65.6
Commercial Banking	43.0	44.8	43.7
Europe	44.2	49.3	46.7
Hong Kong	26.2	24.9	26.1
Rest of Asia-Pacific	41.0	42.9	42.5
North America	46.1	45.1	44.9
Latin America	55.0	54.3	55.9

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HSBC HOLDINGS PLC

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

Financial summary > Group performance > Share of profit in associates and joint ventures / Economic profit

Share of profit in associates and joint ventures

	2008	2007	2006
	US\$m	US\$m	US\$m
Bank of Communications	741	445	259
Ping An Insurance	324	518	245
Industrial Bank	221	128	71
The Saudi British Bank	251	216	258
Other	63	159	(10)
	<hr/>	<hr/>	<hr/>
Share of profit in:			
□ associates	1,600	1,466	823
□ joint ventures	61	37	23
	<hr/>	<hr/>	<hr/>
Share of profit in associates and joint ventures	1,661	1,503	846
	<hr/>	<hr/>	<hr/>

2008 compared with 2007

Share of profit in associates and joint ventures was US\$1.7 billion, an increase of 11 per cent compared with 2007, and 4 per cent on an underlying basis.

This increase was driven by higher contributions from Bank of Communications, Industrial Bank, and The Saudi British Bank, partly offset by lower profits from Ping An Insurance.

HSBC's share of profits from the Bank of Communications rose by 52 per cent to US\$741 million, primarily driven by increased margins, as yields rose following higher base rates in mainland China through most of 2008, and balance sheet growth. Growth in revenues from the asset custody business, financial advisory services and bank card transactions also drove higher profits.

HSBC's share of profits from Ping An Insurance decreased by 43 per cent, primarily due to the impairment of Ping An Insurance's investment in Fortis SA/NV and Fortis N.V. (Fortis Investments), following significant declines in its market value.

Profits from the Saudi British Bank were higher by 16 per cent due to strong balance sheet growth, particularly in the lending portfolio, augmented by higher fees from cards, account services and trade.

Profits from Industrial Bank grew by 72 per cent, driven by increased investment income and balance sheet growth.

The share of profits from joint ventures rose due to growth in HSBC Saudi Arabia Ltd and the recognition of profits in HSBC Merchant Services UK Ltd, the new merchant acquiring venture with Global Payments Inc.

An adjustment to the embedded value of HSBC Assurances in 2007 did not recur.

2007 compared with 2006

Share of profit in associates and joint ventures of US\$1.5 billion was 78 per cent higher than in 2006, on both reported and underlying bases.

Profit from associates and joint ventures rose due to increased contributions from HSBC's strategic investments in mainland China. Profit from Bank of Communications, Ping An Insurance and Industrial Bank improved significantly, driven largely by the thriving local economy.

HSBC's share of profit from Ping An Insurance rose by 101 per cent to US\$518 million as a result of robust growth, notably from life insurance products, and the realisation of synergistic gains across Ping An Insurance's other business offerings.

Profit from the Bank of Communications rose by 64 per cent to US\$445 million as a result of improved performance across the associate's various product offerings. Increased income from credit and treasury products and significant growth in fee income contributed to the increase in profits.

HSBC's share of profits from the Saudi British Bank decreased by 22 per cent to US\$216 million, driven by the effects of a significant correction to the local stock market in the second half of 2006.

A US\$73 million adjustment to the embedded value of HSBC Assurances, an associate in France, resulted in an increase in profits from associates.

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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 the post-tax profit attributable to ordinary shareholders (less goodwill previously amortised in respect of the French regional banks sold in 2008) represents the amount of economic profit generated. Economic profit generated 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 ahead of absolute amounts within business units. In order to ensure consistency and comparability with the five-year strategic plan completed in 2008, the cost of capital on a consolidated basis remains at 10 per cent.

Economic profit decreased by US\$14.8 billion to a loss of US\$8.2 billion. Profit attributable fell, while average shareholders' equity increased marginally. The decline in profit was predominately driven by the US\$10.6 billion goodwill impairment charge relating to the North American Personal Financial Services business, alongside a significant increase in loan impairment charges and write-downs in credit trading, leveraged and acquisition finance, and monoline exposures. The comparative period included dilution gains of US\$1.0 billion (excluding minority interests) which were not repeated. These effects were partially offset by fair value gains on own debt, driven by a widening of credit spreads, of US\$6.6 billion compared with US\$3.1 billion in 2007. The lower return on average invested capital led to a decrease in economic profit and an erosion in economic spread, which fell by 11.3 percentage points compared with 2007. Excluding the goodwill impairment charge, the economic profit spread decreased by 3.6 percentage points compared with 2007.

	2008		2007	
	US\$m	% ¹	US\$m	% ¹
Average total shareholders' equity	122,292		120,346	
Adjusted by:				
Goodwill previously amortised or written off	8,152		8,172	
Property revaluation reserves	(828)		(898)	
Reserves representing unrealised losses on effective cash flow hedges	997		425	
Reserves representing unrealised (gains)/losses on available-for-sale securities	9,163		(1,918)	
Preference shares and other equity instruments	(2,685)		(1,405)	
Average invested capital ²	137,091		124,722	
Return on invested capital ³	5,497	4.0	19,043	15.3
Benchmark cost of capital	(13,709)	(10.0)	(12,472)	(10.0)
Economic profit/(loss) and spread	(8,212)	(6.0)	6,571	5.3

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 amortised pre-transition to IFRSs or subsequently written-off, directly to reserves (less goodwill previously amortised in respect of the French regional banks sold in 2008);

- deducting the average balance of HSBC's revaluation surplus relating to property held for own use. This reserve was generated when determining the deemed carrying cost of such properties on transition to IFRSs and will run down over time as the properties are sold;*
 - deducting average preference shares and other equity instruments issued by HSBC Holdings, and;*
 - deducting average reserves for unrealised gains/(losses) on effective cash flow hedges and available-for-sale securities.*
- 3 *Return on invested capital is based on the profit attributable to ordinary shareholders of the parent company less goodwill previously amortised in respect of the French regional banks sold in 2008.*

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)*Financial summary > Balance sheet > Movement in 2008***Balance sheet**

	At 31 December		
	2008 US\$m	2007 US\$m	2006 US\$m
ASSETS			
Cash and balances at central banks	52,396	21,765	12,732
Trading assets	427,329	445,968	328,147
Financial assets designated at fair value	28,533	41,564	20,573
Derivatives	494,876	187,854	103,702
Loans and advances to banks	153,766	237,366	185,205
Loans and advances to customers	932,868	981,548	868,133
Financial investments	300,235	283,000	204,806
Other assets	137,462	155,201	137,460
Total assets	2,527,465	2,354,266	1,860,758
LIABILITIES AND EQUITY			
Liabilities			
Deposits by banks	130,084	132,181	99,694
Customer accounts	1,115,327	1,096,140	896,834
Trading liabilities	247,652	314,580	226,608
Financial liabilities designated at fair value	74,587	89,939	70,211
Derivatives	487,060	183,393	101,478
Debt securities in issue	179,693	246,579	230,325
Liabilities under insurance contracts	43,683	42,606	17,670
Other liabilities	149,150	113,432	103,010
Total liabilities	2,427,236	2,218,850	1,745,830
Equity			
Total shareholders' equity	93,591	128,160	108,352
Minority interests	6,638	7,256	6,576
Total equity	100,229	135,416	114,928
Total equity and liabilities	2,527,465	2,354,266	1,860,758

A more detailed consolidated balance sheet is contained in the Financial Statements on page 334.

Movement from 31 December 2007 to 31 December 2008

Total assets amounted to US\$2.5 trillion, 7 per cent higher than at 31 December 2007. After excluding currency movements, the disposal of HSBC's French regional subsidiaries and the acquisition of the assets, liabilities and operations of The Chinese Bank in 2008, underlying assets rose by 22 per cent, driven by growth in derivative assets.

The expansion in the Group's balance sheet was largely attributable to increases in derivative assets and liabilities, and was due to growth in the fair value of these positions rather than a rise in their notional contract amounts. Excluding the growth in derivative liabilities, customer accounts formed an increasing share of the Group's liabilities as depositors and savers responded to HSBC's reputation for strength and security. As a result, a proportion of the Group's funding repayable on demand or within one year rose. For information on the Group's management of liquidity, see pages 235 to 240.

The Group's tier 1 capital ratio declined from 9.3 per cent to 8.3 per cent. For detail on regulatory capital and risk weighted assets, see pages 274 to 280.

The following commentary is on an underlying basis.

Assets

The Group's cash and balances at central banks rose substantially, particularly in Hong Kong as additional liquidity was injected into the banking system, and in the US where excess liquidity was required in the short-term as part of a planned transfer of assets between the Group's subsidiaries.

Trading assets increased by 11 per cent. The majority of the rise occurred on 30 September 2008, following the Group's consolidation of five Constant Net Asset Value (CNAV) funds with assets of around US\$40 billion. The decision to consolidate these funds was based on actions taken to support them. For further details of these actions, see page 180. The rise was partly offset by the reclassification of US\$18 billion of trading assets

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partly to □Loans and Advances□ and partly to □Financial investments□ following the changes to International Accounting Standard 39 □ □Financial Instruments □ Recognition and Measurement□ (□IAS39□) issued in October 2008 by the IASB.

Excluding these effects, trading assets remained broadly unchanged as rises in Europe and Asia, where the Group increased its holdings of government bonds, were offset by the run-off of the mortgage-backed securities portfolio in the US and a reduction in debt securities held for balance sheet management purposes due to changes in liquidity and risk preference.

An 18 per cent decline in *financial assets designated at fair value* was driven by falling equity markets, which reduced the value of assets held to meet life insurance liabilities, particularly in Hong Kong and France. To the extent that these liabilities related to unit-linked and participating insurance contracts, there was a corresponding decline in *liabilities under insurance contracts*. The underperformance of certain investment products also led clients to withdraw funds.

Derivative assets rose significantly, led by an increase in interest rate derivatives with further growth in credit and foreign exchange derivatives. The global falls in interest rates resulted in significant gaps between the fixed and floating legs of interest rate swaps, leading to substantial mark-to-market increases in the value of interest rate swap positions. Widening credit spreads and increasing market volatility caused mark-to-market increases in the value of credit derivatives held in the UK and the US. Foreign exchange derivative asset growth was driven by a combination of increased volumes and mark-to-market rises in existing positions in the UK. Under IFRS, only limited netting is allowed between derivative assets and liabilities with the same counterparty, and the balance sheet value is therefore significantly higher than the credit exposure. For information on maximum exposure to credit risk, see pages 197 to 200.

A 29 per cent decline in *loans and advances to banks* occurred mainly in Hong Kong and the UK where Balance Sheet Management invested a greater proportion of its assets in government and government-guaranteed debt.

HSBC also reduced counterparty credit risk in the UK by channelling an increasing proportion of lending to banks through the London Clearing House in the form of reverse repos. This is recorded within customer loans even when the end counterparty is a bank, which means the fall in *loans and advances to banks* and the rise in *loans and advances to*

customers are magnified. The rise in loans and advances to customers was also inflated by the reclassification of US\$15 billion of assets following changes to IAS39 issued in October 2008.

Further increases in *loans and advances to customers* were due to growth in mortgage lending in Europe and Asia, as well as to a rise in overdraft balances to customers whose exposures are managed net but reported gross under IFRS. These rises were offset by a reduction in customer lending in the US due to the run-off of the mortgage services portfolio, the sale of certain loan portfolios at HSBC USA, tighter underwriting criteria which restricted originations in the consumer lending and credit card portfolios, and the cessation of most new originations in the US vehicle finance portfolio.

Financial investments grew by 15 per cent as Balance Sheet Management assets were increasingly classified as available-for-sale financial investments rather than trading assets. As noted above, there was also a rise in financial investments in the UK as the Group placed a greater proportion of surplus funds in government issued or guaranteed debt. The growth in the Group's financial investments was partly offset by a reduction in holdings of asset-backed securities, including those held through special purpose entities, which decreased due to a combination of asset sales, amortisation and write-downs. For details of the Group's asset-backed securities portfolios, see pages 145 to 158.

Liabilities

Deposits by banks rose by 14 per cent, driven, in particular, by increases in France, due to a rise in repo activity to finance increased trading activity, and in Hong Kong, where banks responded to HSBC's reputation for strength and security and deposited their surplus liquidity with the Group.

Customer account balances grew by 16 per cent, driven by strong inflows from customers attracted by HSBC's relative financial strength as they withdrew funds from more volatile investments.

Trading liabilities declined 9 per cent as a fall in third-party funding requirements allowed a reduction in liabilities in Hong Kong, and repo transactions were reduced in Europe to manage liquidity and counterparty credit risk.

A significant widening of credit spreads led to further falls in the fair value of the Group's own debt which reduced *financial liabilities designated at fair value*. This was compounded by a decline in liabilities in the UK due to the underperformance of certain investment products.

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HSBC HOLDINGS PLC

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

Financial summary > Balance sheet > Movement in 2008 / Average balance sheet and NII

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

A decline of 22 per cent in *debt securities in issue* was driven by the US as maturing debt securities did not need replacing as the funding requirements of the consumer finance business declined as its balance sheet contracted. There was also a reduction in debt securities in issue in line with the decrease in holdings of asset-backed securities.

Liabilities under insurance contracts increased by 10 per cent, largely due to new business sales in Hong Kong, France and the UK, partly offset by reduced liabilities on unit-linked policies.

Other liabilities rose by 50 per cent due to the consolidation of the CNAV funds described above.

Equity

Total shareholders' equity declined by 19 per cent, which mainly arose from a decline in the available-for-sale reserve. The continuing market turmoil led to falls in the market values of assets held in HSBC's available-for-sale portfolio. These declines mainly represented market illiquidity rather than impairment of the assets concerned, but they nonetheless reduced the value of the available-for-sale reserve from a positive reserve of US\$0.9 billion to a negative reserve of US\$20.6 billion.

Average balance sheet and net interest income

Average balances and related interest are shown for the domestic operations of HSBC's principal commercial banks by geographical region. 'Other operations' comprise the operations of the principal Commercial Banking and consumer finance entities outside their domestic markets and all other banking operations, including investment banking balances and transactions.

Average balances are based on daily averages for the principal areas of HSBC's banking activities with monthly or less frequent averages used elsewhere.

Balances and transactions with fellow subsidiaries are reported gross in the principal Commercial Banking and consumer finance entities within 'Other interest-earning assets' and 'Other interest-bearing liabilities' as appropriate and the elimination entries are included within 'Other operations' in those two categories.

Net interest margin numbers are calculated by dividing net interest income as reported in the income statement by the average interest-earning assets from which interest income is reported within the 'Net interest income' line of the income statement. Interest income and interest expense arising from trading assets and liabilities and the funding thereof is included within 'Net trading income' in the income statement.

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Assets

		2008			2007			2006		
		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 %
Summary										
Total interest-earning assets (itemised below)		1,466,622	91,301	6.23	1,296,701	92,359	7.12	1,113,404	75,879	6.82
Trading assets ⁷		428,539	16,742	3.91	374,973	17,562	4.68	288,605	12,445	4.31
Financial assets designated at fair value ⁸		37,303	1,108	2.97	14,899	813	5.46	7,681	290	3.78
Impairment provisions		(20,360)			(15,309)			(11,864)		
Non-interest-earning assets		596,885			440,686			291,741		
Total assets and interest income		2,508,989	109,151	4.35	2,111,950	110,734	5.24	1,689,567	88,614	5.24
Short-term funds and loans and advances to banks										
Europe	HSBC Bank	46,703	2,187	4.68	49,910	2,592	5.19	33,856	1,536	4.54
	HSBC Private Banking Holdings (Suisse)	8,040	333	4.14	5,295	229	4.32	4,956	190	3.83
	HSBC France	35,801	1,495	4.18	31,591	1,294	4.10	20,197	690	3.42
Hong Kong	Hang Seng Bank	17,402	587	3.37	13,054	609	4.67	10,360	483	4.66
	The Hongkong and Shanghai Banking Corporation	47,244	1,344	2.84	50,210	2,352	4.68	38,802	1,645	4.24
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	27,907	881	3.16	19,286	810	4.20	13,388	520	3.88
	HSBC Bank Malaysia	4,659	165	3.54	2,861	103	3.60	2,492	87	3.49
	HSBC Bank Middle East	6,028	188	3.12	6,328	324	5.12	4,279	208	4.86
North America	HSBC Bank USA	9,595	328	3.42	9,393	477	5.08	8,422	465	5.52
	HSBC Bank Canada	3,354	107	3.19	3,810	174	4.57	3,167	138	4.36
Latin America	HSBC Mexico	3,682	247	6.71	3,555	239	6.72	3,395	227	6.69
	Brazilian operations ⁹	7,959	951	11.95	5,790	645	11.14	4,129	572	13.85

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HSBC Bank Panama	1,133	30	2.65	897	33	3.68	130	9	6.92
HSBC Bank Argentina	612	43	7.03	304	16	5.26	196	8	4.08
Other operations	19,992	760	3.80	19,087	898	4.70	16,686	618	3.70
	240,111	9,646	4.02	221,371	10,795	4.88	164,455	7,396	4.50

For footnotes, see page 143.

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HSBC HOLDINGS PLC

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

Financial summary > Balance sheet > Average balance sheet and NII

Assets (continued)

		2008			2007			2006		
		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	288,214	18,587	6.45	237,231	18,078	7.62	226,528	14,166	6.25
	HSBC Private Banking Holdings (Suisse)	12,355	494	4.00	9,805	507	5.17	7,134	338	4.74
	HSBC France	73,455	3,604	4.91	68,027	3,219	4.73	52,990	2,463	4.65
	HSBC Finance	4,808	505	10.50	5,492	611	11.13	5,932	671	11.31
Hong Kong	Hang Seng Bank	42,304	1,589	3.76	37,827	2,120	5.60	34,416	1,952	5.67
	The Hongkong and Shanghai Banking Corporation	54,628	2,291	4.19	48,134	2,901	6.03	47,292	2,843	6.01
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	77,741	5,163	6.64	59,286	4,321	7.29	52,159	3,449	6.61
	HSBC Bank Malaysia	8,407	553	6.58	7,467	507	6.79	6,292	430	6.83
	HSBC Bank Middle East	23,697	1,549	6.54	15,125	1,200	7.93	12,757	957	7.50
North America	HSBC Bank USA	93,088	5,758	6.19	90,091	6,585	7.31	88,563	6,141	6.93
	HSBC Finance	140,957	15,835	11.23	153,658	18,086	11.77	147,336	17,061	11.58
	HSBC Bank Canada	48,331	2,455	5.08	43,570	2,598	5.96	35,055	2,037	5.81
Latin America	HSBC Mexico	17,252	2,565	14.87	16,469	2,187	13.28	13,193	1,532	11.61
	Brazilian operations ⁹	19,642	4,879	24.84	13,569	3,895	28.71	9,461	3,244	34.29
	HSBC Bank Panama	8,620	810	9.40	8,113	778	9.59	1,189	92	7.74
	HSBC Bank Argentina	2,136	378	17.70	1,667	241	14.46	838	107	12.77
Other operations		28,027	1,707	6.09	21,318	1,790	8.40	19,795	1,528	7.72
		943,662	68,722	7.28	836,849	69,624	8.32	760,930	59,011	7.76
Financial investments										
Europe	HSBC Bank	83,725	3,840	4.59	45,885	2,431	5.30	42,726	1,977	4.63
		12,018	553	4.60	10,372	511	4.93	8,729	391	4.48

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HSBC Private Banking Holdings (Suisse)										
	HSBC France	14,862	795	5.35	10,357	511	4.93	2,545	95	3.73
Hong Kong	Hang Seng Bank	24,031	1,063	4.42	30,791	1,550	5.03	27,288	1,224	4.49
	The Hongkong and Shanghai Banking Corporation	15,361	563	3.67	20,717	1,017	4.91	20,362	911	4.47
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	31,992	1,507	4.71	23,739	1,065	4.49	17,179	737	4.29
	HSBC Bank Malaysia	937	36	3.84	1,515	56	3.70	954	36	3.77
	HSBC Bank Middle East	5,671	144	2.54	3,654	174	4.76	1,387	72	5.19
North America	HSBC Bank USA	25,089	1,232	4.91	23,373	1,189	5.09	22,214	1,109	4.99
	HSBC Finance	2,908	143	4.92	4,072	229	5.62	3,724	200	5.37
	HSBC Bank Canada	7,037	197	2.80	6,068	258	4.25	4,351	174	4.00
Latin America	HSBC Mexico	3,470	244	7.03	3,327	319	9.59	4,049	427	10.55
	Brazilian operations ⁹	6,758	853	12.62	5,596	672	12.01	3,862	501	12.97
	HSBC Bank Panama	618	47	7.61	709	58	8.18	429	21	4.90
	HSBC Bank Argentina	287	47	16.38	563	68	12.08	311	38	12.22
Other operations		29,632	1,354	4.57	27,252	1,407	5.16	24,742	1,191	4.81
		264,396	12,618	4.77	217,990	11,515	5.28	184,852	9,104	4.93

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		2008			2007			2006	
		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
Other interest-earning assets									
Europe	HSBC Bank	25,885	630	2.43	11,170	652	5.84	9,938	652
	HSBC Private Banking Holdings (Suisse)	21,189	875	4.13	16,360	882	5.39	14,558	732
	HSBC France	23,414	630	2.69	12,158	419	3.45	6,434	173
Hong Kong	Hang Seng Bank	1,629	48	2.95	832	42	5.05	538	28
	The Hongkong and Shanghai Banking Corporation	33,571	949	2.83	27,057	1,237	4.57	19,246	909
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	24,492	352	1.44	11,137	588	5.28	6,938	449
	HSBC Bank Malaysia	212	7	3.30	231	12	5.19	178	10
	HSBC Bank Middle East	843	63	7.47	758	52	6.86	380	32
North America	HSBC Bank USA	3,091	188	6.08	3,731	231	6.19	1,867	82
	HSBC Finance	2,638	63	2.39	1,724	89	5.16	767	43
	HSBC Bank Canada	1,025	25	2.44	960	31	3.23	1,006	32
Latin America	HSBC Mexico	193	2	1.04	□	□	□	□	□
	Brazilian operations ⁹	1,438	147	10.22	840	75	8.93	1,004	190
	HSBC Bank Panama	1,807	23	1.27	1,351	40	2.96	□	□
	HSBC Bank Argentina	58	1	1.72	39	1	2.56	23	3
Other operations		(123,032)	(3,688)		(67,857)	(3,926)		(59,710)	(2,967)
		18,453	315	1.71	20,491	425	2.07	3,167	368

Total interest-earning assets

Europe	HSBC Bank	444,527	25,244	5.68	344,196	23,753	6.90	313,048	18,331
	HSBC Private Banking Holdings (Suisse)	53,602	2,255	4.21	41,832	2,129	5.09	35,377	1,651
	HSBC France Finance	147,532	6,524	4.42	122,133	5,443	4.46	82,166	3,421
		4,808	505	10.50	5,492	611	11.13	5,932	671
Hong Kong	Hang Seng Bank	85,366	3,287	3.85	82,504	4,321	5.24	72,602	3,687
	The Hongkong and Shanghai Banking Corporation	150,804	5,147	3.41	146,118	7,507	5.14	125,702	6,308
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	162,132	7,903	4.87	113,448	6,784	5.98	89,664	5,155
	HSBC Bank Malaysia	14,215	761	5.35	12,074	678	5.62	9,916	563
	HSBC Bank Middle East	36,239	1,944	5.36	25,865	1,750	6.77	18,803	1,269
North America	HSBC Bank USA	130,863	7,506	5.74	126,588	8,482	6.70	121,066	7,797
	HSBC Finance	146,503	16,041	10.95	159,454	18,404	11.54	151,827	17,304
	HSBC Bank Canada	59,747	2,784	4.66	54,408	3,061	5.63	43,579	2,381
Latin America	HSBC Mexico	24,597	3,058	12.43	23,351	2,745	11.76	20,637	2,186
	Brazilian operations ⁹	35,797	6,830	19.08	25,795	5,287	20.50	18,456	4,507
	HSBC Bank Panama	12,178	910	7.47	11,070	909	8.21	1,748	122
	HSBC Bank Argentina	3,093	469	15.16	2,573	326	12.67	1,368	156
Other operations		(45,381)	133		(200)	169		1,513	370
		1,466,622	91,301	6.23	1,296,701	92,359	7.12	1,113,404	75,879

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HSBC HOLDINGS PLC

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

Financial summary > Balance sheet > Average balance sheet and NII

Total equity and liabilities

	2008			2007			2006		
	Average balance US\$m	Interest expense US\$m	Cost %	Average balance US\$m	Interest expense US\$m	Cost %	Average balance US\$m	Interest expense US\$m	Cost %
Summary									
Total interest-bearing liabilities (itemised below)	1,451,842	48,738	3.36	1,279,460	54,564	4.26	1,067,646	41,393	3.88
Trading liabilities	277,940	11,029	3.97	250,572	12,186	4.86	224,050	9,842	4.39
Financial liabilities designated at fair value (excluding own debt issued)	21,266	345	1.62	20,827	224	1.07	12,537	13	0.10
Non-interest-bearing current accounts	98,193			83,958			71,744		
Total equity and other non-interest-bearing liabilities	659,747			477,133			313,590		
Total equity and liabilities	2,508,988	60,112	2.40	2,111,950	66,974	3.17	1,689,567	51,248	3.03

Deposits by banks¹⁰

Europe	HSBC Bank	48,167	1,875	3.89	44,787	2,148	4.80	32,825	1,311	3.99
	HSBC Private Banking Holdings (Suisse)	4,493	105	2.34	690	22	3.19	1,030	33	3.20
	HSBC France	37,851	1,672	4.42	30,816	1,358	4.41	23,171	886	3.82
Hong Kong	Hang Seng Bank	1,696	55	3.24	2,993	123	4.11	2,031	84	4.14
	The Hongkong and Shanghai Banking Corporation	3,665	70	1.91	3,634	150	4.13	2,745	125	4.55
Rest of	The Hongkong and									

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Asia-Pacific	Shanghai Banking Corporation	16,232	450	2.77	10,247	445	4.34	6,276	246	3.92
	HSBC Bank Malaysia	338	10	2.96	375	12	3.20	280	9	3.21
	HSBC Bank Middle East	1,680	29	1.73	672	32	4.76	453	23	5.08
North America	HSBC Bank USA	11,015	220	2.00	6,933	414	5.97	3,695	208	5.63
	HSBC Bank Canada	1,391	41	2.95	1,681	93	5.53	1,520	68	4.47
Latin America	HSBC Mexico	822	32	3.89	983	63	6.41	781	50	6.40
	Brazilian operations ⁹	2,790	190	6.81	1,549	106	6.84	1,033	101	9.78
	HSBC Bank Panama	1,016	43	4.23	1,137	66	5.80	349	17	4.87
	HSBC Bank Argentina	27	1	3.70	117	9	7.69	72	5	6.94
Other operations		4,564	166	3.64	4,495	291	6.47	5,304	334	6.30
		135,747	4,959	3.65	111,109	5,332	4.80	81,565	3,500	4.29

**Financial liabilities
designated at fair
value □ own debt
issued¹¹**

Europe	HSBC Holdings	18,675	721	3.86	15,142	822	5.43	15,132	745	4.92
	HSBC Bank	8,805	529	6.01	9,907	525	5.30	7,888	373	4.73
	HSBC France	1,515	79	5.21	143	11	7.69			
Hong Kong	Hang Seng Bank	127	6	4.72	126	6	4.76			
North America	HSBC Bank USA	1,504	67	4.45	1,620	125	7.72	1,892	116	6.13
	HSBC Finance	32,126	1,563	4.87	31,889	2,079	6.52	29,917	1,877	6.27
Other operations		1,083	168	15.51	□	□	□	461	49	10.63
		63,835	3,133	4.91	58,827	3,568	6.07	55,290	3,160	5.72

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		2008			2007			2006		
		Average balance US\$m	Interest expense US\$m	Cost %	Average balance US\$m	Interest expense US\$m	Cost %	Average balance US\$m	Interest expense US\$m	Cost %
Customer accounts¹²										
Europe	HSBC Bank	305,702	10,092	3.30	270,965	10,576	3.90	221,369	7,031	3.18
	HSBC Private Banking Holdings (Suisse)	37,778	1,349	3.57	30,955	1,485	4.80	25,346	1,069	4.22
	HSBC France	39,428	1,583	4.01	31,845	1,226	3.85	23,579	752	3.19
Hong Kong	Hang Seng Bank	66,142	914	1.38	61,227	1,900	3.10	54,267	1,712	3.15
	The Hongkong and Shanghai Banking Corporation	139,169	1,365	0.98	125,478	3,499	2.79	104,441	2,934	2.81
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	96,476	2,869	2.97	76,052	2,645	3.48	56,760	1,903	3.35
	HSBC Bank Malaysia	10,266	295	2.87	8,823	260	2.95	7,260	212	2.92
	HSBC Bank Middle East	19,922	422	2.12	15,685	578	3.69	11,713	411	3.51
North America	HSBC Bank USA	86,701	2,069	2.39	78,138	3,051	3.90	71,031	2,490	3.51
	HSBC Bank Canada	34,090	967	2.84	30,060	1,090	3.63	25,277	804	3.18
Latin America	HSBC Mexico	14,612	561	3.84	14,230	548	3.85	13,625	471	3.46
	Brazilian operations ⁹	26,288	3,110	11.83	19,581	2,163	11.05	14,887	2,056	13.81
	HSBC Bank Panama	7,761	296	3.81	7,604	314	4.13	998	34	3.41
	HSBC Bank Argentina	2,266	145	6.40	1,892	85	4.49	983	41	4.17
Other operations		64,253	1,952	3.04	55,351	2,297	4.15	49,846	1,811	3.63
		950,854	27,989	2.94	827,886	31,717	3.83	681,382	23,731	3.48

Debt securities in issue

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Europe	HSBC Bank	86,216	4,001	4.64	64,168	3,753	5.85	45,870	2,047	4.46
	HSBC France	30,815	1,447	4.70	28,757	1,207	4.20	19,818	633	3.19
	HSBC Finance	215	8	3.72	240	18	7.50	548	32	5.84
Hong Kong	Hang Seng Bank	1,685	57	3.38	1,734	80	4.61	1,622	64	3.95
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	8,995	640	7.12	8,979	559	6.23	7,990	438	5.48
	HSBC Bank Malaysia	475	20	4.21	318	13	4.09	371	13	3.50
	HSBC Bank Middle East	2,650	90	3.40	2,086	119	5.70	□	□	□
North America	HSBC Bank USA	21,922	852	3.89	25,724	1,232	4.79	28,832	1,407	4.88
	HSBC Finance	98,096	3,765	3.84	115,520	5,311	4.60	112,353	5,047	4.49
	HSBC Bank Canada	16,957	604	3.56	14,771	640	4.33	10,616	460	4.33
Latin America	HSBC Mexico	2,693	243	9.02	1,147	110	9.59	249	23	9.24
	Brazilian operations ⁹	1,859	156	8.39	1,417	115	8.12	700	70	10.00
	HSBC Bank Panama	556	33	5.94	607	45	7.41	35	2	5.71
	HSBC Bank Argentina	2	□	□	12	□	□	□	□	□
Other operations	13,691	66	0.48	6,446	(13)	(0.20)	3,070	108	3.52	
	286,827	11,982	4.18	271,926	13,189	4.85	232,074	10,344	4.46	

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HSBC HOLDINGS PLC

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

Financial summary > Balance sheet > Average balance sheet and NII

Total equity and liabilities (continued)

		2008			2007			2006		
		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	C
Other interest-bearing liabilities										
Europe	HSBC Bank	38,906	1,134	2.91	22,035	1,302	5.91	23,196	1,026	4
	HSBC Private Banking Holdings (Suisse)	4,203	135	3.21	3,427	163	4.76	3,545	155	4
	HSBC France	33,920	1,361	4.01	27,830	979	3.52	13,476	488	3
	HSBC Finance	3,712	191	5.15	4,557	227	4.98	4,211	219	5
Hong Kong	Hang Seng Bank	1,258	41	3.26	2,278	114	5.00	1,378	64	4
	The Hongkong and Shanghai Banking Corporation	10,557	288	2.73	9,866	535	5.42	8,140	365	4
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	23,685	466	1.97	12,631	580	4.59	13,425	629	4
	HSBC Bank Malaysia	338	7	2.07	232	6	2.59	235	9	3
	HSBC Bank Middle East	1,918	89	4.64	1,168	81	6.93	1,046	63	6
North America	HSBC Bank USA	10,490	468	4.46	13,602	587	4.32	11,966	1,211	10
	HSBC Finance	4,670	141	3.02	1,941	113	5.82	542	18	3
	HSBC Bank Canada	1,306	19	1.45	1,151	27	2.35	1,134	22	1

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	HSBC Markets Inc	10,349	78	0.75	8,889	255	2.87	2,883	88	3
Latin America	HSBC Mexico	187	20	10.70	207	16	7.73	135	8	5
	Brazilian operations ⁹	2,340	207	8.85	1,103	182	16.50	817	105	12
	HSBC Bank Panama	917	3	0.33	574	9	1.57	□	□	
	HSBC Bank Argentina	92	6	6.52	95	4	4.21	79	10	12
Other operations	(134,269)	(3,979)		(101,874)	(4,422)		(68,873)	(3,822)		
		14,579	675	4.63	9,712	758	7.80	17,335	658	3
Total interest-bearing liabilities										
Europe	HSBC Bank	487,796	17,631	3.61	411,862	18,304	4.44	331,148	11,788	3
	HSBC Private Banking Holdings (Suisse)	46,474	1,589	3.42	35,072	1,670	4.76	29,921	1,257	4
	HSBC France	143,529	6,142	4.28	119,391	4,781	4.00	80,044	2,759	3
Hong Kong	HSBC Finance	3,927	199	5.07	4,797	245	5.11	4,759	251	5
	Hang Seng Bank	70,908	1,073	1.51	68,358	2,223	3.25	59,298	1,924	3
	The Hongkong and Shanghai Banking Corporation	153,391	1,723	1.12	138,978	4,184	3.01	115,326	3,424	2
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	145,388	4,425	3.04	107,909	4,229	3.92	84,451	3,216	3
	HSBC Bank Malaysia	11,417	332	2.91	9,748	291	2.99	8,146	243	2
	HSBC Bank Middle East	26,170	630	2.41	19,611	810	4.13	13,212	497	3
North America	HSBC Bank USA	131,632	3,676	2.79	126,017	5,409	4.29	117,416	5,432	4
	HSBC Finance	134,892	5,469	4.05	149,350	7,503	5.02	142,812	6,942	4
	HSBC Bank Canada	53,744	1,631	3.03	47,663	1,850	3.88	38,547	1,354	3
Latin America	HSBC Markets Inc	10,349	78	0.75	8,889	255	2.87	2,883	88	3
	HSBC Mexico	18,314	856	4.67	16,567	737	4.45	14,790	552	3
	Brazilian operations ⁹	33,277	3,663	11.01	23,650	2,566	10.85	17,437	2,332	13

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HSBC Bank Panama	10,250	375	3.66	9,922	434	4.37	1,383	53	3
HSBC Bank Argentina	2,387	152	6.37	2,116	98	4.63	1,134	56	4
Other operations	(32,003)	(906)		(20,440)	(1,025)		4,939	(775)	
	<u>1,451,842</u>	<u>48,738</u>	<u>3.36</u>	<u>1,279,460</u>	<u>54,564</u>	<u>4.26</u>	<u>1,067,646</u>	<u>41,393</u>	<u>3</u>

For footnotes, see page
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		2008	2007	2006
		%	%	%
Europe	HSBC Bank	1.71	1.58	2.09
	HSBC Private Banking Holdings (Suisse)	1.24	1.10	1.11
	HSBC France	0.26	0.54	0.81
	HSBC Finance	6.36	6.66	7.08
Hong Kong	Hang Seng Bank	2.59	2.54	2.43
	The Hongkong and Shanghai Banking Corporation	2.27	2.27	2.29
Rest of				
Asia-Pacific	The Hongkong and Shanghai Banking Corporation	2.15	2.25	2.16
	HSBC Bank Malaysia	3.02	3.21	3.23
	HSBC Bank Middle East	3.63	3.63	4.11
North America	HSBC Bank USA	2.93	2.43	1.95
	HSBC Finance	7.22	6.84	6.83
	HSBC Bank Canada	1.93	2.23	2.36
Latin America	HSBC Mexico	8.95	8.60	7.92
	Brazilian operations ⁹	8.85	10.55	11.78
	HSBC Bank Panama	4.39	4.29	3.94
	HSBC Bank Argentina	10.25	8.86	7.31
		2.90	2.91	3.10

Distribution of average total assets

		2008	2007	2006
		%	%	%
Europe	HSBC Bank	36.7	34.6	30.6
	HSBC Private Banking Holdings (Suisse)	2.3	2.2	2.3
	HSBC France	13.8	12.0	10.0
	HSBC Finance	0.2	0.3	0.5
Hong Kong	Hang Seng Bank	3.9	4.4	4.3
	The Hongkong and Shanghai Banking Corporation	9.5	10.1	10.7
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	8.8	6.9	6.0
	HSBC Bank Malaysia	0.6	0.7	0.6
	HSBC Bank Middle East	1.8	1.4	1.3
North America	HSBC Bank USA	11.2	10.1	11.3
	HSBC Finance	6.2	8.3	10.0
	HSBC Bank Canada	2.9	3.3	2.4
Latin America	HSBC Mexico	1.5	2.5	1.7
	Brazilian operations ⁹	2.1	1.6	1.5
	HSBC Bank Panama	0.6	0.7	0.2
	HSBC Bank Argentina	0.2	0.2	0.1
Other operations (including consolidation adjustments)		(2.3)	0.7	6.5

<u>100.0</u>	<u>100.0</u>	<u>100.0</u>
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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)*Financial summary > Balance sheet > Changes in NII*

Analysis of changes in net interest income

The following table allocates changes in net interest income between volume and rate for 2008 compared with 2007, and for 2007 compared with 2006.

Interest income

		Increase/(decrease) in 2008 compared with 2007			Increase/(decrease) in 2007 compared with 2006			
		2008 US\$m	Volume US\$m	Rate US\$m	2007 US\$m	Volume US\$m	Rate US\$m	2006 US\$m
Short-term funds and loans and advances to banks								
Europe	HSBC Bank	2,187	(166)	(239)	2,592	729	327	1,536
	HSBC Private Banking Holdings (Suisse)	333	119	(15)	229	13	26	190
	HSBC France	1,495	173	28	1,294	390	214	690
Hong Kong	Hang Seng Bank	587	203	(225)	609	126	□	483
	The Hongkong and Shanghai Banking Corporation	1,344	(139)	(869)	2,352	484	223	1,645
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	881	362	(291)	810	229	61	520
	HSBC Bank Malaysia	165	65	(3)	103	13	3	87
	HSBC Bank Middle East	188	(15)	(121)	324	100	16	208
North America	HSBC Bank USA	328	10	(159)	477	54	(42)	465
	HSBC Bank Canada	107	(21)	(46)	174	28	8	138
Latin America	HSBC Mexico	247	9	(1)	239	11	1	227
	Brazilian operations ⁹	951	242	64	645	230	(157)	572
	HSBC Bank Panama	30	9	(12)	33	24	□	9
	HSBC Bank Argentina	43	16	11	16	4	4	8
Other operations		760	43	(181)	898	89	191	618
		9,646	915	(2,064)	10,795	2,561	838	7,396

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Loans and advances to customers								
Europe	HSBC Bank	18,587	3,885	(3,376)	18,078	669	3,243	14,166
	HSBC Private Banking Holdings (Suisse)	494	132	(145)	507	127	42	338
	HSBC France	3,604	257	128	3,219	699	57	2,463
	HSBC Finance	505	(76)	(30)	611	(50)	(10)	671
Hong Kong	Hang Seng Bank	1,589	251	(782)	2,120	193	(25)	1,952
	The Hongkong and Shanghai Banking Corporation	2,291	392	(1,002)	2,901	51	7	2,843
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	5,163	1,345	(503)	4,321	471	401	3,449
	HSBC Bank Malaysia	553	64	(18)	507	80	(3)	430
	HSBC Bank Middle East	1,549	680	(331)	1,200	178	65	957
North America	HSBC Bank USA	5,758	219	(1,046)	6,585	106	338	6,141
	HSBC Finance	15,835	(1,495)	(756)	18,086	732	293	17,061
	HSBC Bank Canada	2,455	284	(427)	2,598	495	66	2,037
Latin America	HSBC Mexico	2,565	104	274	2,187	380	275	1,532
	Brazilian operations ⁹	4,879	1,744	(760)	3,895	1,409	(758)	3,244
	HSBC Bank Panama	810	49	(17)	778	686	□	92
	HSBC Bank Argentina	378	68	69	241	106	28	107
Other operations		1,707	564	(647)	1,790	118	144	1,528
		68,722	8,887	(9,789)	69,624	5,891	4,722	59,011

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		Increase/(decrease) in 2008 compared with 2007			Increase/(decrease) in 2007 compared with 2006			
		2008 US\$m	Volume US\$m	Rate US\$m	2007 US\$m	Volume US\$m	Rate US\$m	2006 US\$m
Financial investments								
Europe	HSBC Bank	3,840	2,006	(597)	2,431	146	308	1,977
	HSBC Private Banking Holdings (Suisse)	553	81	(39)	511	74	46	391
	HSBC France	795	222	62	511	291	125	95
Hong Kong	Hang Seng Bank	1,063	(340)	(147)	1,550	157	169	1,224
	The Hongkong and Shanghai Banking Corporation	563	(263)	(191)	1,017	16	90	911
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	1,507	371	71	1,065	281	47	737
	HSBC Bank Malaysia	36	(21)	1	56	21	(1)	36
	HSBC Bank Middle East	144	96	(126)	174	118	(16)	72
North America	HSBC Bank USA	1,232	87	(44)	1,189	58	22	1,109
	HSBC Finance	143	(65)	(21)	229	19	10	200
	HSBC Bank Canada	197	41	(102)	258	69	15	174
Latin America	HSBC Mexico	244	14	(89)	319	(76)	(32)	427
	Brazilian operations ⁹	853	140	41	672	225	(54)	501
	HSBC Bank Panama	47	(7)	(4)	58	37	□	21
	HSBC Bank Argentina	47	(33)	12	68	31	(1)	38
Other operations		1,354	123	(176)	1,407	121	95	1,191
		12,618	2,450	(1,347)	11,515	1,634	777	9,104

Interest expense

Deposits by banks

Europe	HSBC Bank	1,875	162	(435)	2,148	477	360	1,311
	HSBC Private Banking Holdings (Suisse)	105	121	(38)	22	(11)	□	33
	HSBC France	1,672	310	4	1,358	292	180	886
Hong Kong	Hang Seng Bank	55	(53)	(15)	123	40	(1)	84
	The Hongkong and Shanghai Banking Corporation	70	1	(81)	150	40	(15)	125
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	450	260	(255)	445	156	43	246
	HSBC Bank Malaysia	10	(1)	(1)	12	3	□	9
		29	48	(51)	32	11	(2)	23

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	HSBC Bank Middle East							
North America	HSBC Bank USA	220	244	(438)	414	182	24	208
	HSBC Bank Canada	41	(16)	(36)	93	7	18	68
Latin America	HSBC Mexico	32	(10)	(21)	63	13	□	50
	Brazilian operations ⁹	190	85	(1)	106	50	(45)	101
	HSBC Bank Panama	43	(7)	(16)	66	49	□	17
	HSBC Bank Argentina	1	(7)	(1)	9	3	1	5
Other operations		166	4	(129)	291	(51)	8	334
		4,959	1,183	(1,556)	5,332	1,267	565	3,500

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

Financial summary > Balance sheet > Changes in NII / Share capital and reserves

Interest expense (continued)

		Increase/(decrease) in 2008 compared with 2007			Increase/(decrease) in 2007 compared with 2006			
		2008 US\$m	Volume US\$m	Rate US\$m	2007 US\$m	Volume US\$m	Rate US\$m	2006 US\$m
Customer accounts								
Europe	HSBC Bank	10,092	1,355	(1,839)	10,576	1,577	1,968	7,031
	HSBC Private Banking Holdings (Suisse)	1,349	328	(464)	1,485	237	179	1,069
	HSBC France	1,583	292	65	1,226	264	210	752
Hong Kong	Hang Seng Bank	914	152	(1,138)	1,900	219	(31)	1,712
	The Hongkong and Shanghai Banking Corporation	1,365	382	(2,516)	3,499	591	(26)	2,934
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	2,869	711	(487)	2,645	646	96	1,903
	HSBC Bank Malaysia	295	43	(8)	260	46	2	212
	HSBC Bank Middle East	422	156	(312)	578	139	28	411
North America	HSBC Bank USA	2,069	334	(1,316)	3,051	249	312	2,490
	HSBC Bank Canada	967	146	(269)	1,090	152	134	804
Latin America	HSBC Mexico Brazilian operations ⁹	561	15	(2)	548	21	56	471
	HSBC Bank Panama	3,110	741	206	2,163	648	(541)	2,056
	HSBC Bank Argentina	296	6	(24)	314	280	□	34
	HSBC Bank Argentina	145	17	43	85	38	6	41
Other operations		1,952	369	(714)	2,297	200	286	1,811
		27,989	4,710	(8,438)	31,717	5,098	2,888	23,731
		3,133	304	(739)	3,568	196	212	3,160

**Financial liabilities designated
at fair value □ own debt issued****Debt securities in issue**

Europe	HSBC Bank	4,001	1,290	(1,042)	3,753	816	890	2,047
	HSBC France	1,447	86	154	1,207	285	289	633
	HSBC Finance	8	(2)	(8)	18	(18)	4	32
Hong Kong Rest of Asia-Pacific	Hang Seng Bank	57	(2)	(21)	80	4	12	64
	The Hongkong and Shanghai Banking Corporation	640	1	80	559	54	67	438
	HSBC Bank Malaysia	20	6	1	13	(2)	2	13
	HSBC Bank Middle East	90	32	(61)	119	119	□	□
	HSBC Bank USA	852	(182)	(198)	1,232	(152)	(23)	1,407
North America	HSBC Finance	3,765	(802)	(744)	5,311	142	122	5,047
	HSBC Bank Canada	604	95	(131)	640	180	□	460
Latin America	HSBC Mexico	243	148	(15)	110	83	4	23
	Brazilian operations ⁹	156	36	5	115	72	(27)	70
	HSBC Bank Panama	33	(4)	(8)	45	43	□	2
	HSBC Bank Argentina	□	□	□	□	□	□	□
Other operations	66	(14)	93	(13)	119	(240)	108	
	11,982	(723)	(1,930)	13,189	1,777	1,068	10,344	

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Share capital and reserves

Authorised share capital

The authorised share capital of HSBC Holdings at 31 December 2008 was US\$7,500,100,000 divided into 15,000 million ordinary shares of US\$0.50 each and 10 million non-cumulative preference shares of US\$0.01 each; £401,500 divided into 10 million non-cumulative preference shares of £0.01 each and 301,500 non-voting deferred shares of £1 each; and 100,000 divided into 10 million non-cumulative preference shares of 0.01 each.

The percentage of the total authorised share capital of HSBC Holdings at 31 December 2008 represented by the numbers of ordinary shares of US\$0.50 each, non-cumulative preference shares of £0.01 each, non-cumulative preference shares of US\$0.01 each, non-cumulative preference shares of 0.01 each and non-voting deferred shares of £1 each was approximately 99.9890, 0.0019, 0.0013, 0.0019 and 0.0059 per cent respectively.

Issued share capital

The issued share capital of HSBC Holdings at 31 December 2008 was US\$6,052,647,041 divided into 12,105,265,082 ordinary shares of US\$0.50 each and 1,450,000 non-cumulative preference shares of US\$0.01 each; and £301,500 comprising 301,500 non-voting deferred shares of £1 each.

The percentage of the total issued share capital of HSBC Holdings at 31 December 2008 represented by the ordinary shares of US\$0.50 each, non-cumulative preference shares of US\$0.01 each and non-voting deferred shares of £1 each was approximately 99.9925, 0.0002, and 0.0073 per cent respectively.

Rights and obligations attaching to shares

The rights and obligations attaching to each class of share in the authorised share capital of HSBC Holdings are set out in the Articles of Association of HSBC Holdings. Set out below is a summary of the rights and obligations attaching to each class of shares with respect to voting, dividends, capital and, in the case of the preference shares, redemption.

To be registered, a transfer of shares must be in relation to a share which is fully paid up and on which the Company has no lien and to one class of shares denominated in the same currency. The transfer must be in favour of a single transferee or no more than four joint transferees and it must be duly stamped (if required). The transfer must be delivered to the registered office of the Company or to its

Registrars accompanied by the certificate to which it relates or such other evidence that proves the title of the transferor.

If a shareholder or any person appearing to be interested in the Company's shares has been sent a notice under section 793 of the Companies Act 2006 (which confers upon public companies the power to require information from any person whom the Company knows or has reasonable cause to believe to be interested in the shares) and has failed in relation to any shares (the "default shares") to supply the information requested within the period set out in the notice, then the member is not entitled to be present at or to vote the default shares at any general meeting or to exercise any other right conferred by being a shareholder. If the default shares represent at least 0.25 per cent in nominal value of the issued shares of that class any dividend shall be withheld by the Company, without interest and no election for the scrip dividend alternative may be made. No transfer of any shares held by the member will be registered, except in limited circumstances.

Ordinary shares

Subject to the Companies Act 2006 and the Articles of Association of HSBC Holdings, in a general meeting of HSBC Holdings, every holder of ordinary shares who is present in person or by proxy shall on a show of hands have one vote and every holder of ordinary shares present in person or by proxy shall on a poll have one vote for every share he or she holds. Where any shareholder is, under the rules governing the listing of securities on any

stock exchange on which all or any shares of HSBC Holdings are for the time being listed or traded, required to abstain from voting on any particular resolution or restricted to voting only for or only against any particular resolution, any votes cast by or on behalf of such holder in contravention of such requirement or restriction will not be counted.

Subject to the Companies Act 2006 and the Articles of Association of HSBC Holdings, HSBC Holdings may, by ordinary resolution, declare dividends to be paid to the holders of ordinary shares, however, no dividend shall exceed the amount recommended by the Board. The Board may pay interim dividends as appears to the Board to be justified by the profits of HSBC Holdings available for distribution. All dividends shall be apportioned and paid proportionately to the percentage of the nominal amount paid up on the shares during any portion or portions of the period in respect of which the dividend is paid, but if any share is issued on terms providing that it shall rank for dividend as from a particular date, it shall rank for dividend

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HSBC HOLDINGS PLC

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

Financial summary > Balance sheet > Share capital and reserves

accordingly. Subject to the Articles of Association of HSBC Holdings, the Board may, with the prior authority of an ordinary resolution of HSBC Holdings and subject to such terms and conditions as the Board may determine, offer to any holders of ordinary shares the right to elect to receive ordinary shares of the same or a different currency, credited as fully paid, instead of cash in any currency in respect of the whole (or some part, to be determined by the Board) of any dividend specified by the ordinary resolution. At the 2007 Annual General Meeting shareholders gave authority to the Directors to offer a scrip dividend alternative until the conclusion of the Annual General Meeting in 2012.

Subject to the relevant insolvency laws and the Articles of Association of HSBC Holdings, if HSBC Holdings is wound up, the assets available for distribution among the holders of ordinary shares will be distributed among such holders in proportion to the number of ordinary shares held by them respectively, such distribution to be adjusted to take account of any amount remaining unpaid on a holder's share. On a winding up, the liquidator may, with the sanction of a special resolution of HSBC Holdings and any other sanction required by law, divide among the shareholders in specie the whole or any part of the assets of HSBC Holdings and may, for that purpose, value any assets and determine how the division shall be carried out as between the shareholders or different classes of shareholders.

Preference shares

The non-cumulative preference shares of £0.01 each, the non-cumulative preference shares of US\$0.01 each (the Dollar Preference Shares) and the non-cumulative preference shares of 0.01 each carry the same rights and obligations under the Articles of Association save in respect of the timing of and payment of proceeds from the redemption of each class of share, to the extent issued, and certain rights and obligations that attach to each class of preference share as determined by the Board prior to allotment of the relevant preference shares. The Dollar Preference Shares are the only class of the preference shares which have been issued and allotted to date.

Holders of the preference shares will only be entitled to attend and vote at general meetings of HSBC Holdings if any dividend payable on the relevant preference shares in respect of such period as the Board shall determine prior to allotment thereof (which, in the case of the Dollar Preference Shares in issue at 2 March 2009, is four consecutive dividend payment dates) is not paid in full or in such other circumstances, and upon and subject to such

terms, as the Board may determine prior to allotment of the relevant preference shares. Whenever holders of the relevant preference shares are entitled to vote on a resolution at a general meeting, on a show of hands every such holder who is present in person or by proxy shall have one vote and on a poll every such holder who is present in person or by proxy shall have one vote per preference share held by him or her or such number of votes per share as the Board shall determine prior to allotment of such share.

Subject to the Articles of Association, holders of the relevant preference shares shall have the right to a non-cumulative preferential dividend at such rate, on such dates and on such other terms and conditions as may be determined by the Board prior to allotment thereof in priority to the payment of any dividend to the holders of ordinary shares and any other class of shares of HSBC Holdings in issue (other than (i) the other preference shares in issue and any other shares expressed to rank *pari passu* therewith as regards income; and (ii) any shares which by their terms rank in priority to the relevant preference shares as regards income). Dividends on the Dollar Preference Shares in issue at 2 March 2009 are paid quarterly at the sole and absolute discretion of the Board of Directors. The Board of Directors will not declare a dividend on the Dollar Preference Shares if

payment of the dividend would cause HSBC Holdings not to meet the applicable capital adequacy requirements of the FSA or the profit of HSBC Holdings available for distribution as dividends is not sufficient to enable HSBC Holdings to pay in full both dividends on the relevant preference shares and dividends on any other shares that are scheduled to be paid on the same date and that have an equal right to dividends. HSBC Holdings may not declare or pay dividends on any class of its shares ranking lower in the right to dividends than the preference shares nor redeem nor purchase in any manner any of its other shares ranking equal with or lower than the preference shares unless it has paid in full, or set aside an amount to provide for payment in full, the dividends on the preference shares for the then-current dividend period.

The preference shares carry no rights to participate in the profits or assets of HSBC Holdings other than as set out in the Articles of Association and subject to the Companies Act 1985, do not confer any right to participate in any offer or invitation by way of rights or otherwise to subscribe for additional shares in HSBC Holdings, do not confer any right of conversion and do not confer any right to participate in any issue or bonus shares or

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shares issued by way of capitalisation of reserves.

Subject to the relevant insolvency laws and the Articles of Association of HSBC Holdings, holders of the relevant preference shares have the right in a winding up of HSBC Holdings to receive out of the assets of HSBC Holdings available for distribution to its shareholders, in priority to any payment to the holders of the ordinary shares and any other class of shares of HSBC Holdings in issue (other than (i) the other relevant preference shares and any other shares expressed to rank *pari passu* therewith as regards repayment of capital; and (ii) any shares which by their terms rank in priority to the relevant preference shares as regards repayment of capital), a sum equal to any unpaid dividend on the relevant preference shares which is payable as a dividend in accordance with or pursuant to the Articles of Association and the amount paid up or credited as paid up on the relevant preference shares together with such premium (if any) as may be determined by the Board prior to allotment thereof.

HSBC Holdings may redeem the relevant preference shares in accordance with the Articles of Association and the terms on which the relevant preference shares were issued and allotted. In the case of the Dollar Preference Shares in issue at 2 March 2009, HSBC Holdings may redeem such shares in whole at any time on or after 16 December 2010, subject to prior notification to the FSA.

Non-voting deferred shares

The non-voting deferred shares are held by a subsidiary undertaking of HSBC Holdings. Holders of the non-voting deferred shares are not entitled to receive dividends on these shares. In addition, on winding up or other return of capital, holders are entitled to receive the amount paid up on their shares after distribution to ordinary shareholders of £10 million in respect of each ordinary share held by them. The holders of the non-voting deferred shares are not entitled to receive notice of or to attend (either personally or by proxy) any general meeting of HSBC Holdings or to vote (either personally or by proxy) on any resolution to be proposed thereat.

The following events occurred during the year in relation to the share capital of HSBC Holdings:

Scrip dividends

1. 36,524,050 ordinary shares were issued at par in January 2008 to shareholders who elected to receive new shares in lieu of the third interim dividend for 2007. The market value per share used to calculate shareholders' entitlements to new shares was US\$16.821, being the US dollar equivalent of £8.132.
2. 136,165,605 ordinary shares were issued at par in May 2008 to shareholders who elected to receive new shares in lieu of the fourth interim dividend for 2007. The market value per share used to calculate shareholders' entitlements to new shares was US\$16.4022, being the US dollar equivalent of £8.132.
3. 15,191,514 ordinary shares were issued at par in July 2008 to shareholders who elected to receive new shares in lieu of the first interim dividend for 2008. The market value per share used to calculate shareholders' entitlements to new shares was US\$16.8421, being the US dollar equivalent of £8.519.
4. 47,687,930 ordinary shares were issued at par in October 2008 to shareholders who elected to receive new shares in lieu of the second interim dividend for 2008. The market value per share used to calculate shareholders' entitlements to new shares was US\$15.2466, being the US dollar equivalent of £8.266.

All-Employee share plans

5. In connection with the exercise of options under the HSBC Holdings savings-related share option plans: 27,491,176 ordinary shares were issued at prices ranging from £5.3496 to £7.6736 per share; 1,782,367 ordinary shares were issued at prices ranging from HK\$103.4401 to HK\$108.4483 per share; 805,885 ordinary shares were issued at prices ranging from US\$13.3290 to US\$14.7478 per share; and 46,698 ordinary shares were issued at £10.4217 per share. Options over 18,163,336 ordinary shares lapsed.

6. 2,667,632 ordinary shares were issued at £8.3124 per share in connection with a Plan d'Épargne Entreprise for the benefit of non-UK resident employees of HSBC France and its subsidiaries.
7. Options over 32,951,305 ordinary shares were granted at nil consideration on 30 April 2008 to nearly 70,000 HSBC employees resident in nearly 70 countries and territories under the HSBC Holdings savings-related share option plans.

Discretionary share incentive plans

8. 4,050,585 ordinary shares were issued at prices ranging from £6.2767 to £7.460 per share in connection with the exercise of options under

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HSBC HOLDINGS PLC

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

Financial summary > Balance sheet > Share capital and reserves / Short-term borrowings > Contractual obligations / Ratios

the HSBC Holdings Executive Share Option Scheme. Options over 223,951 ordinary shares lapsed.

9. 3,734,125 ordinary shares were issued at prices ranging from £6.9100 to £8.7120 per share in connection with the exercise of options under the HSBC Holdings Group Share Option Plan. Options over 5,889,067 ordinary shares lapsed.
10. No options were exercised under and no ordinary shares were issued in connection with the HSBC Share Plan. Options over 224,728 ordinary shares lapsed.

HSBC Finance

11. 65,198 ordinary shares were issued at prices ranging from US\$14.59 to US\$16.71 per share in connection with the vesting of Restricted Stock Rights under HSBC Finance share plans that have been converted into rights over HSBC Holdings ordinary shares.

Authority to purchase ordinary shares

12. At the Annual General Meeting in 2008, shareholders renewed the authority for the Company to make market purchases of ordinary shares. The authority is to make market purchases of up to 1,186,700,000 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 2008 shareholders renewed the general authority for the Directors to allot new shares. The general authority is to allot up to 2,373,400,000 ordinary shares, 10,000,000 non-cumulative preference shares of £0.01 each, 8,550,000 non-cumulative preference shares of \$0.01 each and 10,000,000 non-cumulative preference shares of \$0.01 each. Within this, the Directors have authority to allot up to a maximum of 593,350,000 ordinary shares wholly for cash to persons other than existing shareholders.

Other than as described in paragraphs 1 to 6 and 8 to 10 above, the Directors did not allot any shares during 2008.

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.

	2008	2007	2006
	US\$m	US\$m	US\$m
Securities sold under agreements to repurchase			
Outstanding at 31 December	145,180	140,001	97,139
Average amount outstanding during the year	177,256	129,779	102,715
Maximum quarter-end balance outstanding during the year	190,651	148,601	109,689
Weighted average interest rate during the year	3.8%	5.4%	4.3%
Weighted average interest rate at the year-end	2.9%	4.8%	4.6%
Short-term bonds			
Outstanding at 31 December	40,279	51,792	37,906
Average amount outstanding during the year	45,330	39,153	37,729
Maximum quarter-end balance outstanding during the year	55,842	51,792	38,907
Weighted average interest rate during the year	5.0%	7.0%	5.1%
Weighted average interest rate at the year-end	3.1%	6.5%	4.8%

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Contractual obligations

The table below provides details of HSBC's material contractual obligations as at 31 December 2008.

	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	254,946	92,191	99,353	63,402
Term deposits and certificates of deposit	256,661	245,672	10,989	□
Capital (finance) lease obligations	979	55	188	736
Operating lease obligations	4,139	766	1,800	1,573
Purchase obligations	1,541	948	593	□
Short positions in debt securities and equity shares	66,774	52,679	4,477	9,618
Current tax liability	1,822	1,822	□	□
Pension obligations	15,137	1,208	5,393	8,536
	601,999	395,341	122,793	83,865

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

	2008 %	2007 %	2006 %	2005 %	2004 %
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Ratios of earnings to combined fixed charges and preference share dividends

Ratios in accordance with IFRSs

□ excluding interest on deposits	2.97	6.96	7.22	9.16	8.64
□ including interest on deposits	1.13	1.34	1.40	1.59	1.86

Ratios in accordance with UK GAAP

□ excluding interest on deposits	□	□	□	□	8.07
□ including interest on deposits	□	□	□	□	1.81

Ratios of earnings to combined fixed charges

Ratios in accordance with IFRSs

□ excluding interest on deposits	3.17	7.52	7.93	9.60	8.64
□ including interest on deposits	1.14	1.34	1.41	1.59	1.86

Ratios in accordance with UK GAAP

□ excluding interest on deposits	□	□	□	□	8.07
□ including interest on deposits	□	□	□	□	1.81

For the purpose of calculating the ratios, earnings consist of income from continuing operations before taxation and minority interests, plus fixed charges, and after deduction of the unremitted pre-tax income of associated undertakings. Fixed charges consist of total interest expense, including or excluding interest on deposits, as appropriate, dividends on preference shares and other equity instruments, as applicable, and the proportion of rental expense deemed representative of the interest factor.

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HSBC HOLDINGS PLC

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

Financial summary > Balance sheet > Loan maturities / Deposits

Loan maturity and interest sensitivity analysis

At 31 December 2008, 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	58,520	29,258	35,668	10,966	11,919	146,331
Commercial loans to customers						
Commercial, industrial and international trade	83,772	14,666	31,433	5,611	8,827	144,309
Real estate and other property related	18,430	6,253	6,071	9,527	1,497	41,778
Non-bank financial institutions	57,853	1,070	4,188	21,490	1,116	85,717
Governments	1,121	117	1,260	243	309	3,050
Other commercial	35,652	1,919	5,648	8,737	1,955	53,911
	196,828	24,025	48,600	45,608	13,704	328,765
Hong Kong Government Home Ownership Scheme Residential mortgages and other personal loans	□	442	□	□	□	442
Loans and advances to customers	227,164	37,943	62,572	81,727	22,086	431,492
	285,684	67,201	98,240	92,693	34,005	577,823
Maturity after 1 year but within 5 years						
Loans and advances to banks	3,152	388	398	442	190	4,570
Commercial loans to customers						
Commercial, industrial and international trade	23,889	4,943	7,360	8,087	3,640	47,919
Real estate and other property related	13,760	13,716	6,182	8,002	790	42,450
Non-bank financial institutions	3,419	594	1,111	3,112	1,185	9,421
Governments	323	784	355	78	769	2,309

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Other commercial	11,839	3,365	4,130	3,214	2,072	24,620
	53,230	23,402	19,138	22,493	8,456	126,719
Hong Kong Government Home Ownership Scheme Residential mortgages and other personal loans	□ 1,404	□	□	□	□	1,404
	31,595	8,991	9,948	52,234	5,755	108,523
Loans and advances to customers	84,825	33,797	29,086	74,727	14,211	236,646
	87,977	34,185	29,484	75,169	14,401	241,216

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

11,333 185 2,734 5,066 2,460 21,778 Variable interest rate **45,049 23,605 16,802 17,869 6,186 109,511**

56,382 23,790 19,536 22,935 8,646 131,289

Maturity after 5 years Loans and advances to banks **340 □75 50 2,463 2,928**

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

Fixed interest rate

7,607 **942** **1,128** **619** **10,296** Variable interest rate **31,193** **7,439** **3,167** **7,591** **4,308** **53,698**

38,800 **7,439** **4,109** **8,719** **4,927** **63,994**

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Deposits

The following tables summarise the average amount of bank deposits, customer deposits and certificates of deposit (□CDs□) and other money market instruments (which are included within □Debt securities in issue□ in the balance sheet), together

with the average interest rates paid thereon for each of the past three years. The geographical analysis of average deposits is based on the location of the office in which the deposits are recorded and excludes balances with HSBC companies. The □Other□ category includes securities sold under agreements to repurchase.

	2008		2007		2006	
	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	5,231	□	6,359	□	9,814	□
Demand □ interest bearing	19,204	3.2	11,036	3.8	8,368	3.7
Time	43,695	3.9	38,470	4.7	27,447	4.0
Other	31,098	4.4	28,770	4.8	23,396	3.5
	99,228		84,635		69,025	
Hong Kong						
Demand and other □ non-interest bearing	1,375	□	1,331	□	1,031	□
Demand □ interest bearing	2,780	2.0	2,420	4.3	2,428	4.6
Time	1,583	2.7	3,267	4.5	2,016	4.3
Other	178	3.4	251	0.4	362	3.3
	5,916		7,269		5,837	
Rest of Asia-Pacific						
Demand and other □ non-interest bearing	1,911	□	1,897	□	1,618	□
Demand □ interest bearing	4,332	2.3	3,167	2.4	1,960	2.4
Time	10,342	3.5	6,433	5.1	3,645	4.8
Other	3,769	3.3	2,768	4.8	2,157	4.5
	20,354		14,265		9,380	
North America						
Demand and other □ non-interest bearing	761	□	827	□	767	□
Demand □ interest bearing	5,684	1.7	3,759	4.8	3,033	5.3

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Time	7,941	2.3	6,746	6.0	3,543	5.4
Other	449	1.6	169	7.1	699	5.6
	14,835		11,501		8,042	
Latin America						
Demand and other □ non-interest bearing	366	□	808	□	702	□
Demand □ interest bearing	81	2.5	153	5.9	96	6.3
Time	3,357	5.6	2,690	6.5	1,732	5.5
Other	1,254	7.8	1,010	8.0	683	9.4
	5,058		4,661		3,213	
Total						
Demand and other □ non-interest bearing	9,644	□	11,222	□	13,932	□
Demand □ interest bearing	32,081	2.7	20,535	3.8	15,885	4.5
Time	66,918	3.7	57,606	4.9	38,383	4.5
Other	36,748	4.5	32,968	5.0	27,297	3.9
	145,391		122,331		95,497	

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)*Financial summary > Balance sheet > Deposits / CDs // Critical accounting policies*

	2008		2007		2006	
	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	39,610	□	34,585	□	33,000	□
Demand □ interest bearing	225,034	2.9	210,692	3.5	173,150	2.7
Savings	73,479	4.3	62,002	4.6	50,525	3.9
Time	83,208	3.8	69,476	4.9	59,374	4.2
Other	26,651	3.9	14,741	4.5	9,249	4.1
	447,982		391,496		325,298	
Hong Kong						
Demand and other □ non-interest bearing	15,620	□	14,214	□	13,011	□
Demand □ interest bearing	126,199	0.4	107,053	2.2	88,754	2.4
Savings	65,068	2.4	63,649	3.9	58,883	3.8
Time	27,659	2.3	26,712	3.9	20,454	3.6
Other	1,563	1.2	1,164	4.3	51	3.9
	236,109		212,792		181,153	
Rest of Asia-Pacific						
Demand and other □ non-interest bearing	22,721	□	16,438	□	13,107	□
Demand □ interest bearing	55,653	1.9	41,089	2.4	29,816	2.1
Savings	68,968	3.6	57,950	4.2	42,153	4.3
Time	15,226	3.3	11,538	4.6	10,246	4.5
Other	1,359	2.8	1,835	4.5	2,233	3.5
	163,927		128,850		97,555	
North America						
Demand and other □ non-interest bearing	16,759	□	15,175	□	13,662	□
Demand □ interest bearing	18,261	1.6	15,389	3.3	14,406	2.9
Savings	87,001	2.5	79,529	3.3	65,216	2.8
Time	17,838	3.2	17,655	5.9	21,124	5.4

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Other	5,123	2.4	3,234	3.7	3,339	2.0
	144,982		130,982		117,747	
Latin America						
Demand and other □ non-interest bearing	12,507	□	10,530	□	7,995	□
Demand □ interest bearing	4,994	1.9	5,662	2.1	5,438	1.6
Savings	31,442	10.3	24,861	8.8	16,512	11.3
Time	15,179	5.2	12,443	5.9	7,665	5.9
Other	949	8.2	1,212	9.5	2,145	13.4
	65,071		54,708		39,755	
Total						
Demand and other □ non-interest bearing	107,217	□	90,942	□	80,775	□
Demand □ interest bearing	430,141	1.9	379,885	3.0	311,564	2.6
Savings	325,958	3.9	287,991	4.4	233,289	4.1
Time	159,110	3.6	137,824	4.9	118,863	4.5
Other	35,645	3.6	22,186	4.7	17,017	4.8
	1,058,071		918,828		761,508	
CDs and other money market instruments						
Europe	74,007	4.5	66,164	5.0	48,238	4.2
Hong Kong	745	3.0	941	3.9	1,191	3.5
Rest of Asia-Pacific	7,614	6.4	7,230	6.0	6,621	5.6
North America	22,278	3.3	23,735	5.4	23,472	4.6
Latin America	3,036	7.8	1,526	6.8	318	10.7
	107,680	4.5	99,596	5.2	79,840	4.5

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Certificates of deposit and other time deposits

At 31 December 2008, the maturity analysis of CDs and other wholesale time deposits, by remaining maturity, was as follows:

	3 months or less US\$m	After 3 months but within 6 months US\$m	After 6 months but within 12 months US\$m	After 12 months US\$m	Total US\$m
Europe					
Certificates of deposit	23,911	483	192	□	24,586
Time deposits:					
□ banks	34,951	1,943	2,418	4,649	43,961
□ customers	78,562	5,140	4,135	1,598	89,435
	<u>137,424</u>	<u>7,566</u>	<u>6,745</u>	<u>6,247</u>	<u>157,982</u>
Hong Kong					
Certificates of deposit	145	137	280	904	1,466
Time deposits:					
□ banks	1,031	5	□	67	1,103
□ customers	21,898	1,057	274	419	23,648
	<u>23,074</u>	<u>1,199</u>	<u>554</u>	<u>1,390</u>	<u>26,217</u>
Rest of Asia-Pacific					
Certificates of deposit	2,324	1,383	928	248	4,883
Time deposits:					
□ banks	3,912	887	310	164	5,273
□ customers	13,106	1,651	670	1,490	16,917
	<u>19,342</u>	<u>3,921</u>	<u>1,908</u>	<u>1,902</u>	<u>27,073</u>
North America					
Time deposits:					
□ banks	10,209	2	5	201	10,417
□ customers	13,882	720	248	310	15,160
	<u>24,091</u>	<u>722</u>	<u>253</u>	<u>511</u>	<u>25,577</u>
Latin America					
Certificates of deposit	1,161	640	60	316	2,177
Time deposits:					
□ banks	2,360	1,446	389	264	4,459
□ customers	10,357	1,389	1,071	359	13,176

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	13,878	3,475	1,520	939	19,812
Total					
Certificates of deposit	27,541	2,643	1,460	1,468	33,112
Time deposits:					
□ banks	52,463	4,283	3,122	5,345	65,213
□ customers	137,805	9,957	6,398	4,176	158,336
	217,809	16,883	10,980	10,989	256,661

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.

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 significant accounting policies used in the preparation of the consolidated financial statements are described in Note 2 on the Financial Statements.

When preparing the financial statements, it is the Directors' responsibility under UK company law to select suitable accounting policies and to make judgements and estimates that are reasonable and prudent.

The accounting policies that are deemed critical to HSBC's results and financial position, in terms of the materiality of the items to which the policy is applied, and which involve a high degree of judgement including the use of assumptions and estimation, are discussed below.

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HSBC HOLDINGS PLC

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

Critical accounting policies

Impairment of loans and advances

HSBC's accounting policy for losses arising from the impairment of customer loans and advances is described in Note 2g on the Financial Statements. Loan impairment allowances represent management's best estimate of losses incurred in the loan portfolios at the balance sheet date.

Management is required to exercise judgement in making assumptions and estimations when calculating loan impairment allowances on both individually and collectively assessed loans and advances. Of the Group's total loans and advances to customers before impairment allowances of US\$957 billion (2007: US\$1,001 billion), US\$6.9 billion or 1 per cent (2007: US\$6.5 billion; 1 per cent) were individually assessed for impairment, and US\$950 billion or 99 per cent (2007: US\$994 billion; 99 per cent) were collectively assessed for impairment.

The most significant judgemental area is the calculation of collective impairment allowances. HSBC's most significant geographical area of exposure to collectively assessed loans and advances is North America, which comprised US\$271 billion or 29 per cent (2007: US\$301 billion; 30 per cent) of HSBC's total collectively assessed loans and advances. Collective impairment allowances in North America were US\$15.9 billion, representing 77 per cent (2007: US\$11.9 billion; 72 per cent) of the total collectively assessed loan impairment allowance.

HSBC uses two alternative methods to calculate collective impairment allowances on homogeneous groups of loans that are not considered individually significant:

- when appropriate empirical information is available, HSBC utilises roll-rate methodology. This methodology employs statistical analysis of historical data and experience of delinquency and default to estimate the likelihood that loans will progress through the various stages of delinquency and ultimately prove irrecoverable. The estimated loss is the difference between the present value of expected future cash flows, discounted at the original effective interest rate of the portfolio, and the carrying amount of the portfolio; and
- in other cases, when the portfolio size is small or when information is insufficient or not reliable enough to adopt a roll-rate methodology, HSBC adopts a formulaic approach which allocates progressively higher percentage loss rates the longer a customer's

loan is overdue. Loss rates are based on historical experience.

Both methodologies are subject to estimation uncertainty, in part because it is not practicable to identify losses on an individual loan basis because of the large number of individually insignificant loans in the portfolio.

In addition, the use of statistically assessed historical information is supplemented with significant management judgement to assess whether current economic and credit conditions are such that the actual level of inherent losses is likely to be greater or less than that suggested by historical experience. In normal circumstances, historical experience provides the most objective and relevant information from which to assess inherent loss within each portfolio. In certain circumstances, historical loss experience provides less relevant information about the inherent loss in a given portfolio at the balance sheet date, for example, where there have been changes in economic, regulatory or behavioural conditions such that the most recent trends in the portfolio risk factors are not fully reflected in the statistical models. In these circumstances, such risk factors are taken

into account when calculating the appropriate levels of impairment allowances, by adjusting the impairment allowances derived solely from historical loss experience.

This key area of judgement is subject to uncertainty and is highly sensitive to factors such as loan portfolio growth, product mix, unemployment rates, bankruptcy trends, geographic concentrations, loan product features, economic conditions such as national and local trends in housing markets, the level of interest rates, portfolio seasoning, account management policies and practices, changes in laws and regulations, and other factors that can affect customer payment patterns. Different factors are applied in different regions and countries to reflect different economic conditions and laws and regulations. The assumptions underlying this judgement are highly subjective. The methodology and the assumptions used in calculating impairment losses are reviewed regularly in the light of differences between loss estimates and actual loss experience. For example, roll rates, loss rates and the expected timing of future recoveries are regularly benchmarked against actual outcomes to ensure they remain appropriate.

The total amount of the Group's impairment allowances on homogeneous groups of loans is inherently uncertain because it is highly sensitive to changes in economic and credit conditions across a

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large number of geographical areas. Economic and credit conditions within geographical areas are influenced by many factors with a high degree of interdependency so that there is no single factor to which the Group's loan impairment allowances as a whole are sensitive. However, HSBC's loan impairment allowances are particularly sensitive to general economic and credit conditions in North America. For example, a 10 per cent increase in impairment allowances on collectively assessed loans and advances in North America would increase loan impairment allowances by US\$1.6 billion at 31 December 2008 (2007: US\$1.2 billion). It is possible that the outcomes within the next financial year could be different from the assumptions built into the models, resulting in a material adjustment to the carrying amount of loans and advances.

Goodwill impairment

HSBC's accounting policy for goodwill is described in Note 2(p) on the Financial Statements. Note 22 on the Financial Statements lists the Group's cash generating units (CGUs) by geographical region and global business. Total goodwill for the Group amounted to US\$22 billion as at 31 December 2008 (2007: US\$34 billion).

The process of identifying and evaluating goodwill impairment is inherently uncertain because it requires significant management judgement in making a series of estimations, the results of which are highly sensitive to the assumptions used. The review of goodwill impairment represents management's best estimate of the factors below:

- the future cash flows of the CGUs are sensitive to the cash flows projected for the periods for which detailed forecasts are available, and to assumptions regarding the long-term pattern of sustainable cash flows thereafter. Forecasts are compared with actual performance and verifiable economic data in future years; however, the cash flow forecasts necessarily and appropriately reflect management's view of future business prospects at the time of the assessment; and
- the discount rate used to discount the future expected cash flows is based on the cost of capital assigned to an individual CGU, and can have a significant effect on the CGU's valuation. The cost of capital percentage is generally derived from a Capital Asset Pricing Model, which incorporates inputs reflecting a number of financial and economic variables, including the risk-free interest rate in the country concerned and a premium to reflect the

inherent risk of the business being evaluated. These variables are subject to fluctuations in external market rates and economic conditions outside of management's control and are therefore established on the basis of significant management judgement and are subject to uncertainty.

When this exercise demonstrates that the expected cash flows of a CGU have declined and/or that its cost of capital has increased, the effect is to reduce the CGU's estimated recoverable amount. 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 recognised in HSBC's income statement for the year.

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

Given the extraordinary market events experienced globally during the second half of 2008, HSBC performed an additional impairment test on all the CGUs within the Group as at 31 December 2008. As a result, HSBC recognised an impairment charge of US\$10.6 billion on Personal Financial Services - North America as at 31 December 2008 (2007: nil). Management concluded that the recoverable amount of the other CGUs to which goodwill has been allocated exceeded their carrying value. However, in the event of further significant deterioration in the economic and credit conditions beyond the levels already reflected by management in the cash flow forecasts for the CGUs, a material adjustment to a CGU's recoverable amount may occur which may result in the recognition of an impairment charge in the income statement.

Note 22 on the Financial Statements includes details of the CGUs with significant balances of goodwill, states the key assumptions used to assess the goodwill in each of those CGUs for impairment, and provides a discussion of the sensitivity of the carrying value of goodwill to changes in key assumptions.

Valuation of financial instruments

HSBC's accounting policy for determining the fair value of financial instruments is described in Note 2d on the Financial Statements.

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HSBC HOLDINGS PLC

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

The best evidence of fair value is a quoted price in an actively traded market. In the event that the market for a financial instrument is not active, a valuation technique is used. The majority of valuation techniques employ only observable market data, and so the reliability of the fair value measurement is high. However, certain financial instruments are valued on the basis of valuation techniques that feature one or more significant market inputs that are unobservable. Valuation techniques that rely to a greater extent on unobservable inputs require a higher level of management judgement to calculate a fair value than those based wholly on observable inputs.

Valuation techniques used to calculate fair values include comparisons with similar financial instruments for which market observable prices exist, discounted cash flow analysis, option pricing models and other valuation techniques commonly used by market participants. Valuation techniques incorporate assumptions that other market participants would use in their valuations, including assumptions about interest rate yield curves, exchange rates, volatilities, and prepayment and default rates. When valuing instruments by reference to comparable instruments, management takes into account the maturity, structure and rating of the instrument with which the position held is being compared.

The main assumptions and estimates which management considers when applying a model with valuation techniques are:

- the likelihood and expected timing of future cash flows on the instrument. These cash flows are usually governed by the terms of the instrument, although management judgement may be required when the ability of the counterparty to service the instrument in accordance with the contractual terms is in doubt. Future cash flows may be sensitive to changes in market rates;
- selecting an appropriate discount rate for the instrument. Management bases the determination of this rate on its assessment of what a market participant would regard as the appropriate spread of the rate for the instrument over the appropriate risk-free rate; and
- judgement to determine what model to use to calculate fair value in areas where the choice of valuation model is particularly subjective, for example, when valuing complex derivative products.

When applying a model with unobservable inputs, estimates are made to reflect uncertainties in fair values resulting from a lack of market data inputs, for example, as a result of illiquidity in the market. For these instruments, the fair value measurement is less reliable. Inputs into valuations based on unobservable data are inherently uncertain because there are little or no current market data available from which to determine the level at which an arm's length transaction would occur under normal business conditions. However, in most cases there are some market data available on which to base a determination of fair value, for example historical data, and the fair values of most financial instruments will be based on some market observable inputs even where the unobservable inputs are significant.

An analysis of the basis for valuation of financial instruments measured at fair value in the financial statements is provided on page 162. The value of financial assets and liabilities that use a valuation technique are US\$876 billion (2007: US\$626 billion) and US\$671 billion (2007: US\$401 billion) or 71 per cent (2007: 66 per cent) and 83 per cent (2007: 68 per cent) of total assets and total liabilities measured at fair value, respectively. A sensitivity analysis of fair values for financial instruments with significant unobservable inputs to reasonably possible alternative assumptions and a range of assumptions and inputs used in valuation models in respect of instruments of particular interest in the current market turmoil can be found on page 164. Given the uncertainty

and subjective nature of valuing financial instruments at fair value, it is possible that the outcomes in the next financial year could differ from the assumptions used, and this could result in a material adjustment to the carrying amount of financial instruments measured at fair value.

Impairment of available-for-sale financial assets

HSBC's accounting policy for impairment of available-for-sale financial assets is described in Note 2(j) on the Financial Statements.

Available-for-sale financial assets are measured at fair value, and changes in fair value are recognised in equity in the available-for-sale fair value reserve until the financial assets are either sold or become impaired. An impairment loss is recognised if there is objective evidence of impairment as a result of loss events which have an impact on the estimated future cash flows of the financial asset that can be reliably estimated. If an available-for-sale financial asset becomes impaired, the entire balance in equity

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relating to that asset is removed from equity and recognised in the income statement as an impairment loss. A further decline in the fair value of an available-for-sale debt security subsequent to the initial impairment is recognised in the income statement when there is further objective evidence of impairment.

At 31 December 2008 the Group's total available-for-sale financial assets amounted to US\$286 billion (2007: US\$273 billion), of which US\$279 billion or 98 per cent (2007: US\$261 billion; 95 per cent) were debt securities. At 31 December 2008, the available-for-sale fair value reserve relating to debt securities amounted to a deficit of US\$21.4 billion (2007: deficit of US\$2.4 billion). A deficit in the available-for-sale fair value reserve occurs on an available-for-sale debt security when the fair value of the security is less than the security's acquisition cost (net of any principal repayments and amortisation) less any previous impairment loss recognised in the income statement, but there is no evidence of any impairment or, if an impairment was previously recognised, any subsequent impairment.

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

The objective evidence required to determine whether an available-for-sale debt security is impaired comprises evidence of the occurrence of a loss event and evidence that the loss event results in a decrease in estimated future cash flows. Where cash flows are readily determinable, a low level of judgement may be involved. Where determination of estimated future cash flows requires consideration of a number of variables, some of which may be unobservable in current market conditions, more significant judgement is required.

The most significant judgements concern more complex instruments, such as asset-backed securities ([ABS](#)s), where it is necessary to consider factors such as the estimated future cash flows on underlying pools of collateral, the extent and depth of market price declines and changes in credit ratings. The review of estimated future cash flows on underlying collateral is subject to estimation uncertainties where the assessment is based on historical information on pools of assets, and

judgement is required to determine whether historical performance is likely to be representative of current economic and credit conditions. A description of these securities is included in the [Impact of market turmoil](#) section under [Nature and extent of HSBC's exposures](#) on page 150 and a more detailed description of the assumptions and estimates used in assessing these securities for impairment is disclosed in the section [Assessing available-for-sale assets for impairment](#) on page 170.

There is no single factor to which the Group's charge for impairment of available-for-sale debt securities is particularly sensitive, because of the range of different types of securities held, the range of geographical areas in which those securities are held, and the wide range of factors which can affect the occurrence of loss events and the cash flows of securities, including different types of collateral.

Management's current assessment of the holdings of available-for-sale ABSs with the most sensitivity to possible future impairment is focused on sub-prime and Alt-A residential mortgage-backed securities ([MBS](#)s). The Group's principal exposure to these securities is in the Global Banking and Markets' business. Excluding holdings in certain special purpose entities where significant first loss risks are borne by external investors, the available-for-sale holdings in these categories within Global Banking and Markets amounted to US\$5.2 billion at 31 December 2008 (2007: US\$11.8 billion). The deficit in the available-for-sale fair value reserve as at 31 December 2008 in relation to these securities was US\$5.9 billion (2007: US\$1.1 billion).

The main factors in the reduction in fair value of these securities over the period were the effects of reduced market liquidity and negative market sentiment. The level of actual credit losses experienced was low in 2008, notwithstanding the deterioration in the performance of the underlying mortgages in the period as US house prices fell and defaults increased. The absence of material credit losses is judged to be attributable to the seniority of the tranches held by HSBC as well as the priority for cash flow held by these tranches.

Further details of the nature and extent of HSBC's exposures to asset backed securities classified as available-for-sale are provided in "Impact of market turmoil" nature and extent of HSBC's exposures on page 150.

It is reasonably possible that outcomes in the next financial year could be different from the assumptions and estimates used in identifying

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HSBC HOLDINGS PLC

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

Critical accounting policies / Customer groups > Summary

impairment on available-for-sale debt securities, as a result of which, evidence of impairment may be identified in available-for-sale debt securities which had previously been determined not to be impaired. It is possible that this could result in the recognition of material impairment losses in the next financial year.

Deferred tax assets

HSBC's accounting policy for the recognition of deferred tax assets is described in Note 2s on the Financial Statements. A deferred tax asset is recognised to the extent that it is probable that future taxable profits will be available against which deductible temporary differences can be utilised. The recognition of a deferred tax asset relies on management's judgements surrounding the probability and sufficiency of future taxable profits, future reversals of existing taxable temporary differences and ongoing tax planning strategies.

HSBC's most significant judgements are around the US deferred tax assets, where there has been a recent history of losses in HSBC's US operations. Net US deferred tax assets amounted to US\$5.0 billion or 71 per cent (2007: US\$3.7 billion; 70 per cent) of total net deferred tax assets recognised on the Group's balance sheet.

The amount of US deferred tax assets recognised is based on the evidence available about conditions at the balance sheet date, and requires significant judgements to be made by management, especially those based on management's projections of credit losses and the timing of recovery in the US economy. Management's judgement takes into consideration the impact of both positive and negative evidence, including historical financial performance, projections of future taxable income, future reversals of existing taxable temporary differences, and the availability of loss carrybacks. The recognition of the deferred tax asset is mainly dependent upon the projection of future taxable profits, future reversals of existing taxable temporary differences and the capacity to carry back net operating losses arising in 2009.

Tax losses were incurred in HSBC's US operations in 2008. Management has evaluated the factors contributing to the losses to determine whether the factors leading to the losses are temporary or indicative of a permanent decline in earnings. Based on its analysis, management has

determined that the losses were primarily caused by increases in credit losses in the US due to the current housing and credit market conditions, as well as continued weakening in the general economy, which has led to higher unemployment levels and, consequently, higher credit losses.

In the US, management's projections of future taxable income are based on business plans, future capital requirements and ongoing tax planning strategies. These projections include assumptions about the depth and severity of further house price depreciation, assumptions about the US recession, including unemployment levels and their related impact on credit losses, and assumptions about ongoing capital support from HSBC.

The assumptions surrounding future expected credit losses in the US represent the most subjective areas of judgement in management's projections of future taxable income.

Management's forecasts support the assumption that it is probable that the results of future operations will generate sufficient taxable income to utilise the deferred tax assets. In management's judgement, the recent market conditions, which have resulted in losses being incurred in the US over the last two years, will create significant downward pressure and volatility on the profit or loss before tax in the next few years. To reflect this, the assessment of recoverability of the deferred tax asset in the US significantly discounts any future expected

taxable income and relies to a greater extent on continued capital support to the US operations from HSBC, including tax planning strategies implemented in relation to such support. The most significant tax planning strategy is HSBC's investment of capital into its US operations to ensure the utilisation of the net operating loss carry forwards. This strategy provides substantial support for the recoverability of the deferred tax assets. HSBC expects that its US operations will continue to be dependent upon its capital support, and will continue to execute their business strategies and plans until they return to profitability. Based on management's forecasts, HSBC expects to provide capital support to its US operations in each of the next three years. If HSBC were to decide, however, not to provide this ongoing support, the full recovery of the deferred tax asset may no longer be probable and could result in a material adjustment to the deferred tax asset which would be recognised in the income statement.

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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 2008. Based upon that evaluation, the Group Chairman and Group Finance Director concluded that HSBC's disclosure controls and procedures as of 31 December 2008 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 2008 that has materially affected, or is reasonably likely to materially affect, HSBC Holdings' internal control over financial reporting.

Management's assessment of internal control over financial reporting

Management is responsible for establishing and maintaining an adequate internal control structure and procedures for financial reporting, and has completed an assessment of the effectiveness of the Group's internal control over financial reporting as of 31 December 2008. In making the assessment, management used the framework for Director's internal control evaluation contained within the Combined Code (The Revised Turnbull Guidance), as well as the criteria established by the Committee of Sponsoring Organisations of the Treadway Commission (COSO) in Internal Control-Integrated Framework.

Based on the assessment performed, management concluded that as at 31 December 2008, 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 2008, has also audited the effectiveness of the Group's internal control over financial reporting under Auditing Standard No.5 of the Public Company Accounting Oversight Board (United States) as stated in their report on pages 330 and 331.

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Customer groups and global businesses

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Summary	

HSBC manages its business through two customer groups, Personal Financial Services and Commercial Banking, and two global businesses, Global Banking and Markets (previously Corporate, Investment Banking and Markets), and Private Banking. Personal Financial Services incorporates the Group's consumer finance businesses; the largest of these is HSBC Finance Corporation (HSBC Finance).

All commentaries on the customer groups and global businesses are on an underlying basis unless stated otherwise.

Profit/(loss) before tax

	2008		2007		2006	
	US\$m	%	US\$m	%	US\$m	%
Personal Financial Services	(10,974)	(117.9)	5,900	24.4	9,457	42.8
Commercial Banking	7,194	77.3	7,145	29.5	5,997	27.2
Global Banking and Markets	3,483	37.4	6,121	25.3	5,806	26.3
Private Banking	1,447	15.6	1,511	6.2	1,214	5.5
Other ¹³	8,157	87.6	3,535	14.6	(388)	(1.8)
	9,307	100.0	24,212	100.0	22,086	100.0

Total assets¹⁵

	At 31 December			
	2008		2007	
	US\$m	%	US\$m	%
Personal Financial Services	514,419	20.4	621,356	26.4
Commercial Banking	249,218	9.9	307,944	13.1
Global Banking and Markets	1,896,630	75.0	1,561,468	66.3
Private Banking	133,216	5.3	130,893	5.6

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Other	135,001	5.3	155,685	6.6
Intra-HSBC items	(401,019)	(15.9)	(423,080)	(18.0)
	2,527,465	100.0	2,354,266	100.0

For footnotes, see page 145.

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 Group Management Office (GMO) functions, to the extent that these

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

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

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HSBC HOLDINGS PLC

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

Profit/(loss) before tax

	2008	2007	2006
	US\$m	US\$m	US\$m
Net interest income	29,419	29,069	26,076
Net fee income	10,107	11,742	8,762
Trading income excluding net interest income	175	38	391
Net interest income on trading activities	79	140	220
Net trading income ¹⁶	254	178	611
Net income/(expense) from financial instruments designated at fair value	(2,912)	1,333	739
Gains less losses from financial investments	663	351	78
Dividend income	90	55	31
Net earned insurance premiums	10,083	8,271	5,130
Other operating income	259	387	782
Total operating income	47,963	51,386	42,209
Net insurance claims ¹⁷	(6,474)	(8,147)	(4,365)
Net operating income⁵	41,489	43,239	37,844
Loan impairment charges and other credit risk provisions	(21,220)	(16,172)	(9,949)
Net operating income	20,269	27,067	27,895
Operating expenses (excluding goodwill impairment)	(21,140)	(21,757)	(18,818)
Goodwill impairment	(10,564)	□	□
Operating profit/(loss)	(11,435)	5,310	9,077
Share of profit in associates and joint ventures	461	590	380
Profit/(loss) before tax	(10,974)	5,900	9,457
By geographical region			
Europe	1,658	1,581	1,909
Hong Kong	3,428	4,212	2,880
Rest of Asia-Pacific	500	760	477
North America	(17,228)	(1,546)	3,391
Latin America	668	893	800

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	(10,974)	5,900	9,457
	%	%	%
Share of HSBC's profit before tax	(117.9)	24.4	42.8
Cost efficiency ratio	76.4	50.3	49.7
Balance sheet data ¹⁵	US\$m	US\$m	US\$m
Loans and advances to customers (net)	401,402	464,726	448,545
Total assets	514,419	621,356	602,342
Customer accounts	440,338	450,071	388,468

For footnotes, see page 143.

Strategic direction

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

- markets where HSBC already has scale, such as Hong Kong and the UK; and
- markets where HSBC can build or acquire scale, particularly in Asia-Pacific, Latin America, Turkey and the Middle East.

Within these markets, there are two key target segments:

- customers who value seamless international banking and wealth management; and
- customers who are confident about using direct channels (internet, ATM, telephone, mobile) to access financial services.

Financial performance in 2008

- The reported loss before tax of US\$11.0 billion compared with a profit of US\$5.9 billion in 2007, driven substantially by higher loan impairment charges and a goodwill impairment charge of US\$10.6 billion which wrote down in full the goodwill relating to the North American Personal Financial Services business. Excluding the loss before tax incurred in this business, pre-tax profits fell by 17 per cent on an underlying basis, with an increase in loan impairments and lower fee income more than offsetting an increase in revenue from deposit growth and higher gains on the sale of MasterCard and Visa shares.
- Net fee income fell by 13 per cent. This was driven by weak market sentiment, which resulted in lower fees from retail securities and investments, particularly in Hong Kong, and changes in fee billing practices in the credit card business to improve the customer proposition in North America.
- A net expense of US\$2.9 billion was recorded on financial instruments designated at fair value, compared with income of US\$1.3 billion in 2007. This was largely due to the fall in value of assets held to meet liabilities under insurance and investment contracts driven by poor equity market performances, predominantly affecting operations in Hong Kong, the UK and France.
For assets held to meet liabilities under unit-linked and, to a certain extent, participating insurance contracts, the movement from income to expense was offset by a corresponding

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reduction in policyholder liabilities where investment losses can be passed to policyholders.

- Loan impairment charges rose by 32 per cent, primarily due to further deterioration in credit quality in the North American Personal Financial Services business. Delinquency rates increased across all portfolios in HSBC Finance, particularly consumer lending, and in the real estate secured portfolios in HSBC USA, following the sustained downturn in the housing market and the onset of economic recession.
- A rise in loan impairments in Mexico, Turkey and India was attributable to higher delinquencies following growth of the credit card and personal loan portfolios. Actions taken to curtail asset growth in these markets focused on tightening lending criteria and deploying advanced credit analytics.
- Operating expenses were 48 per cent higher, largely due to the goodwill impairment charge. Excluding this, operational costs were slightly lower, driven by a 12 per cent reduction in North America following initiatives taken since 2007 to cease originations in mortgage services, limit new originations in consumer lending and reduce marketing spend in cards. This benefit was partially offset by investment in business expansion in mainland China and Japan and an increase in restructuring costs and union-agreed salaries in Latin America.
- Profit before tax increased in Europe, with a solid performance in the UK partially offset by a fall in Turkey as an investment in 98 additional branches was made in order to attain nationwide coverage. Profits were lower in France.
- In the Middle East, profit rose by 17 per cent on 2007, with strong growth in revenue from cards.

Business highlights in 2008

- HSBC Premier (Premier), which offers mass affluent customers a seamless international banking and wealth management service, grew to 2.6 million customers in 2008. During the year, the service was extended to a further six countries, taking the total to 41. 472,000 net new customers joined Premier, of whom 80 per cent were new to the Group.
- The strength of the HSBC brand helped attract an increase in customer accounts of US\$50 billion, or 13 per cent, to US\$440 billion, despite the low interest rate environment. In North America, net loans and advances to customers fell by 16 per cent as HSBC reduced its balance sheet and lowered its risk profile in the US. Excluding North America, lending increased by 10 per cent, demonstrating HSBC's commitment to supporting its core customer base. At 31 December 2008, the advances-to-deposits ratio was 91 per cent, compared with 106 per cent at the end of December 2007.
- The HSBC Direct online savings offering in the US performed well in difficult market conditions. Average balances increased by US\$2.0 billion to US\$13.2 billion, reducing the overall funding costs of the US Personal Financial Services business.
- In the UK, HSBC launched a RateMatcher mortgage promotion to attract quality customers facing an interest rate reset in the near term. HSBC attracted a strong flow of new business totalling US\$9.9 billion during the campaign. In December 2008, HSBC announced that the bank will make available up to £15 billion of UK residential mortgages in 2009.
- Consistent with HSBC's strategy to increase the sale of insurance products to existing customers, the major life businesses in Europe and Asia grew and underlying net premium income rose by 15 per cent. However, declining worldwide equity markets led to a reduction in insurance profits compared with 2007.

- In the US, declining house prices, rising unemployment and increasing bankruptcies fuelled growing customer delinquencies. HSBC continued to take measures to help customers manage their mortgage repayments and avoid foreclosure. During 2008, HSBC Finance expanded its mortgage loan modification programme which included longer-term modifications. The loan obligations of over 92,000 customers with aggregate mortgages of US\$13.5 billion were modified during 2008, helping to maximise cash flow for HSBC and preserve home ownership for customers.

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HSBC HOLDINGS PLC

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

Customer groups > Personal Financial Services

Subsequent developments

The branch-based US consumer lending business of HSBC Finance has historically focused on sub-prime customers who rely on drawing cash against the equity in their homes to help meet their cash needs. Unsecured consumer lines of credit have served as a means of generating new customer accounts, with the potential to subsequently provide the customer with a mortgage product, typically a secured debt consolidation loan. As a result, the bulk of the mortgage lending products sold in the US consumer lending branch network have been for refinancing and debt consolidation rather than for house purchase.

The unprecedented deterioration in the US housing market over the last two years, including declining property values and lower secondary market demand for sub-prime mortgages, has undermined the ability of many real estate loan customers to make payments or refinance their loans. In many cases, there is no equity in their homes or, if there is, few institutions are willing to finance its withdrawal. As a result, loan originations in this business have fallen dramatically for both HSBC Finance and the industry as a whole. Management believes it will take years before property values return to the levels seen prior to the decline and, as such, has concluded that recovery in the sub-prime mortgage lending business is uncertain and the industry is unlikely to stabilise for a number of years. Management also expects that changes in regulation and practice will make it problematic to plan and execute a sub-prime lending business strategy with a reasonable degree of confidence.

Given the above, in 2008 HSBC began to reposition its US consumer lending business to reduce risk by tightening lending criteria and expanding its lending to include government sponsored entity and conforming loan products. As part of this repositioning, HSBC intended to place greater emphasis on unsecured loan products while decreasing secured loan production. To date, the results of this repositioning effort have not met expectations, in part due to the continued deterioration in the economy, leading management to re-evaluate whether, given the Group's risk appetite, the initiative can produce the volume necessary to ensure that the consumer lending business will return to profitability in the foreseeable future.

As a consequence, at the end of February 2009, the Board of HSBC endorsed management's recommendation to discontinue as soon as practicable originations of all products by the branch-based US consumer lending business of HSBC Finance. At 31 December 2008 this business had outstanding balances of US\$62 billion comprising US\$46 billion in real estate secured and US\$16 billion in unsecured loan balances. HSBC will continue to service and collect the existing loan portfolio as it runs off, and will continue the Group's efforts to help customers in need of loan modification and other account management programmes to maximise collection and preserve, as far as possible, home ownership. In the US, substantially all consumer lending branches branded HFC and Beneficial will cease taking loan applications and will be closed. HSBC Finance will also continue to run-off the loan portfolios of its mortgage services business and its vehicle finance business. HSBC will provide all necessary support to HSBC Finance to enable it to run off these businesses in a measured way and to meet all its commitments.

The operations of HSBC's other US Personal Financial Services businesses, including its card business, and the retail bank branch business of HSBC USA are unaffected by this decision. HSBC USA will continue to service its customers with real estate secured and unsecured products.

HSBC expects as a result of this decision affecting the US consumer lending business of HSBC Finance that total revenue will fall by approximately US\$50 million in 2009 and operating expenses by approximately US\$700 million on an annualised basis. Closure costs of up to US\$195 million will be incurred, predominantly related to one-off termination and other employee benefit costs, a substantial portion of which will be recorded in the first half of 2009.

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In addition, a non-cash charge of approximately US\$70 million is expected to be incurred in relation to the impairment of fixed assets associated with the consumer lending branch network, also to be recognised in the first half of 2009.

Employees supporting originations operations will be evaluated for service elsewhere in HSBC's operations, but it is currently expected that approximately 6,100 employees will be displaced.

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Reconciliation of reported and underlying profit/(loss) before tax

2008 compared with 2007

Personal Financial Services	2007	2007	Currency	2007	2008	Under-	2008	Re-
	as reported US\$m	acquisitions, disposals & dilution gains ¹ US\$m	translation ² US\$m	at 2008 exchange rates ³ US\$m	acquisitions and disposals ¹ US\$m	lying change US\$m	as reported US\$m	ported change %
Net interest income	29,069	(224)	(126)	28,719	215	485	29,419	1
Net fee income	11,742	(21)	(105)	11,616	(9)	(1,500)	10,107	(14)
Other income ⁴	2,428	(91)	(10)	2,327	83	(447)	1,963	(19)
Net operating income⁵	43,239	(336)	(241)	42,662	289	(1,462)	41,489	(4)
Loan impairment charges and other credit risk provisions	(16,172)	4	75	(16,093)	(3)	(5,124)	(21,220)	(31)
Net operating income	27,067	(332)	(166)	26,569	286	(6,586)	20,269	(25)
Operating expenses (excluding goodwill impairment)	(21,757)	236	117	(21,404)	(98)	362	(21,140)	3
Goodwill impairment	□	□	□	□	□	(10,564)	(10,564)	n/a
Operating profit/(loss)	5,310	(96)	(49)	5,165	188	(16,788)	(11,435)	(315)
Income from associates	590	□	52	642	□	(181)	461	(22)
Profit/(loss) before tax	5,900	(96)	3	5,807	188	(16,969)	(10,974)	(286)

2007 compared with 2006

Personal Financial Services	2006	2006	Currency	2006	2007	Under-	2007	Re-	Under-
	as reported US\$m	acquisitions and disposals ¹ US\$m	translation ² US\$m	at 2007 exchange rates ⁶ US\$m	acquisitions, disposals & dilution gains ¹ US\$m	lying change US\$m	as reported US\$m	ported change %	lying change %

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Net interest income	26,076	(3)	746	26,819	653	1,597	29,069	11	6
Net fee income	8,762	53	322	9,137	(77)	2,682	11,742	34	30
Other income ⁴	3,006	(53)	87	3,040	(38)	(574)	2,428	(19)	(19)
Net operating income ⁵	37,844	(3)	1,155	38,996	538	3,705	43,239	14	10
Loan impairment charges and other credit risk provisions	(9,949)	□	(205)	(10,154)	(72)	(5,946)	(16,172)	(63)	(59)
Net operating income	27,895	(3)	950	28,842	466	(2,241)	27,067	(3)	(8)
Operating expenses	(18,818)	2	(753)	(19,569)	(285)	(1,903)	(21,757)	(16)	(10)
Operating profit	9,077	(1)	197	9,273	181	(4,144)	5,310	(42)	(45)
Income from associates	380	□	13	393	6	191	590	55	49
Profit before tax	9,457	(1)	210	9,666	187	(3,953)	5,900	(38)	(41)

For footnotes, see page 143.

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HSBC HOLDINGS PLC

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

Profit before tax

	2008	2007	2006
	US\$m	US\$m	US\$m
Net interest income	9,494	9,055	7,514
Net fee income	4,097	3,972	3,207
Trading income excluding net interest income	369	265	204
Net interest income on trading activities	17	31	20
Net trading income ¹⁶	386	296	224
Net income/(expense) from financial instruments designated at fair value	(224)	22	(22)
Gains less losses from financial investments	193	90	44
Dividend income	88	8	6
Net earned insurance premiums	679	733	258
Other operating income	939	165	250
Total operating income	15,652	14,341	11,481
Net insurance claims ¹⁷	(335)	(391)	(96)
Net operating income⁵	15,317	13,950	11,385
Loan impairment charges and other credit risk provisions	(2,173)	(1,007)	(697)
Net operating income	13,144	12,943	10,688
Total operating expenses	(6,581)	(6,252)	(4,979)
Operating profit	6,563	6,691	5,709
Share of profit in associates and joint ventures	631	454	288
Profit before tax	7,194	7,145	5,997
By geographical region			
Europe	2,722	2,516	2,234
Hong Kong	1,315	1,619	1,321
Rest of Asia-Pacific	1,793	1,350	1,034
North America	658	920	957

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Latin America	706	740	451
	7,194	7,145	5,997
	%	%	%
Share of HSBC's profit before tax	77.3	29.5	27.2
Cost efficiency ratio	43.0	44.8	43.7
Balance sheet data ¹⁵			
	US\$m	US\$m	US\$m
Loans and advances to customers (net)	203,949	220,068	172,976
Total assets	249,218	307,944	228,668
Customer accounts	235,879	237,987	190,853

For footnotes, see page 143.

Strategic direction

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

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

Financial performance in 2008

- Reported pre-tax profit was broadly in line with 2007 at US\$7.2 billion as revenue growth was offset by the rise in loan impairment charges and operating costs. Pre-tax profit growth was evident in emerging markets, with their contribution increasing to 56 per cent excluding a gain of US\$425 million on the disposal of the UK merchant acquiring division, recorded in [Other operating income]. Profit growth was most significant in Australia, India, mainland China, United Arab Emirates ([UAE]), Turkey, Brazil and Argentina.
- HSBC remained committed to new lending, increasing lending balances by 10 per cent. Deposit growth of 15 per cent was driven by brand strength, particularly in the UK, the US and Hong Kong.
- Balance sheet growth drove a 7 per cent rise in net interest income, notwithstanding the adverse affect of widespread reductions in interest rates on liability spreads. This was partly offset by higher lending spreads from improved pricing.
- Net fee income rose by 8 per cent with income from trade services and foreign exchange growing particularly strongly.
- Other income was boosted by a number of significant gains, notably from the sale of shares in MasterCard and Visa.
- Loan impairment charges increased from US\$1.0 billion in 2007 to US\$2.2 billion, as the previously benign

credit environment was replaced by economic slowdown in most countries. Loan impairment charges increased by 44 basis points to 1 per cent of average reported assets, with most of the increase coming in the second half of 2008.

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- The cost efficiency ratio improved to 44.2 per cent excluding the US\$425 million gains noted above. Costs were tightly controlled in Europe and North America, but grew elsewhere as the Group continued to expand operations in emerging markets, particularly in Asia.
- Customer numbers grew to 2.9 million, with continuing recruitment of new customers through existing operations and gains from the acquisition of the assets, liabilities and operations of The Chinese Bank in Taiwan, despite a reduction from the sale of the French regional banks.

Business highlights in 2008

Commercial Banking achieved key objectives toward its international business strategy in 2008 as the proportion of its total revenues derived from international customers and products increased.

- Revenue from foreign exchange and trade and supply chain products grew strongly, with increases of 66 per cent and 27 per cent, respectively. This was driven by improved cross-selling of products, particularly in foreign exchange, as customers sought protection from volatile currency movements. A number of initiatives were launched to extend foreign exchange services, which included enhancing relationship management in the US and UAE, and introducing dedicated sales desks in India.
- The volume of international trade finance increased significantly and revenue grew commensurately as HSBC benefited from higher commodity prices, the reintermediation of traditional trade instruments in respect of which the Group demonstrated continued capacity to lend, and improved pricing reflecting market trends. HSBC's growth outpaced market growth in a number of key countries, particularly in Asia and the Middle East.
- Successful Global Links referrals nearly doubled to 5,600, with the aggregate transaction value exceeding US\$11 billion, an increase of 96 per cent. The use of electronic account opening [SmartForms] improved customer experience.

In support of its strategy to be the best bank for small businesses, HSBC focused on deposit gathering and transaction banking, and was particularly successful in attracting customer deposits.

- With over US\$100 billion in customer deposits, HSBC's small and micro segments are a significant source of funding for Commercial Banking, generating over twice as much in liabilities as loans and advances to customers. Customer numbers in the small and micro segments rose by 7 per cent to 2.6 million. In Taiwan, the acquisition of the assets, liabilities and operations of The Chinese Bank expanded the branch network to 33 and added over 15,000 small business customers.
- Customer loyalty was evidenced by an increase in the use of internet banking, with the number of active users of Business Internet Banking growing by 16 per cent and the number of transactions by 18 per cent.
- New small business offerings continued to be initiated. BusinessDirect was extended to seven countries and total customer numbers exceeded 180,000. BusinessVantage was launched in Indonesia while, in the US, the autumn marketing campaign led to over 9,000 new accounts. New business card products were rolled out in a further six countries.
- The announcement of HSBC's US\$5 billion International SME Fund in December underscored the Group's commitment to lending to small and medium-sized enterprises, and led to significant interest from existing and prospective customers. Specific initiatives were launched in the UK, Hong Kong, France and Malta.

Commercial Banking increased its intra-Group referrals, in part by extending the Global Links platform to facilitate cross-customer group referrals.

- In Hong Kong and India, an initiative to increase referrals across customer groups resulted in a two-fold rise in the number of Premier account referrals, and significant growth in referrals from Personal Financial Services to Commercial Banking. Similar programmes in the UK contributed to sales of Premier accounts and mortgage products, and plans are underway to extend these programmes to other regions in 2009.
- Referrals to Private Banking grew by 30 per cent, and led to US\$2.7 billion in new assets under management, while referrals from Private Banking led to a three-fold increase in new relationships.
- Sales of Global Markets products were particularly strong in foreign exchange under Commercial Banking's strategy to be the leading bank for international business.

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)*Customer groups > Commercial Banking / Global Banking and Markets*

Reconciliation of reported and underlying profit before tax

2008 compared with 2007

	2007 as reported	2007 acquisitions, disposals & dilution gains ¹	Currency translation ²	2007 at 2008 exchange rates ³	2008 acquisitions and disposals ¹	Under- lying change	2008 as reported	Re- ported change
Commercial Banking	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m	%
Net interest income	9,055	(166)	(77)	8,812	41	641	9,494	5
Net fee income	3,972	(113)	(76)	3,783	27	287	4,097	3
Other income ⁴	923	(7)	(28)	888	525	313	1,726	87
Net operating income⁵	13,950	(286)	(181)	13,483	593	1,241	15,317	10
Loan impairment charges and other credit risk provisions	(1,007)	3	36	(968)	(3)	(1,202)	(2,173)	(116)
Net operating income	12,943	(283)	(145)	12,515	590	39	13,144	2
Operating expenses	(6,252)	180	47	(6,025)	(106)	(450)	(6,581)	(5)
Operating profit	6,691	(103)	(98)	6,490	484	(411)	6,563	(2)
Income from associates	454	□	26	480	□	151	631	39
Profit before tax	7,145	(103)	(72)	6,970	484	(260)	7,194	1

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2007 compared with 2006

	2006 as reported	2006 acquisitions and disposals ¹	Currency translation ²	2006 at 2007 exchange rates ⁶	2007 acquisitions, disposals & dilution & gains ¹	Under- lying change	2007 as reported	Re- ported change	Under- lying change
Commercial Banking	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m	%	%
Net interest income	7,514	□	382	7,896	114	1,045	9,055	21	13
Net fee income	3,207	□	189	3,396	17	559	3,972	24	16
Other income ⁴	664	□	27	691	48	184	923	39	27
Net operating income ⁵	11,385	□	598	11,983	179	1,788	13,950	23	15
Loan impairment charges and other credit risk provisions	(697)	□	(47)	(744)	(61)	(202)	(1,007)	(44)	(27)
Net operating income	10,688	□	551	11,239	118	1,586	12,943	21	14
Operating expenses	(4,979)	□	(291)	(5,270)	(73)	(909)	(6,252)	(26)	(17)
Operating profit	5,709	□	260	5,969	45	677	6,691	17	11
Income from associates	288	□	9	297	1	156	454	58	53
Profit before tax	5,997	□	269	6,266	46	833	7,145	19	13

For footnotes, see page 143.

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

Profit before tax

	2008	2007	2006
	US\$m	US\$m	US\$m
Net interest income	8,541	4,430	3,168
Net fee income	4,291	4,901	3,718
Trading income excluding net interest income	157	3,503	4,890
Net interest income/ (expense) on trading activities	324	(236)	(379)
Net trading income ¹⁶	481	3,267	4,511
Net income/(expense) from financial instruments designated at fair value	(438)	(164)	20
Gains less losses from financial investments	(327)	1,313	534
Dividend income	76	222	235
Net earned insurance premiums	105	93	73
Other operating income	868	1,218	1,378
Total operating income	13,597	15,280	13,637
Net insurance claims ¹⁷	(79)	(70)	(62)
Net operating income⁵	13,518	15,210	13,575
Loan impairment (charges)/ recoveries and other credit risk provisions	(1,471)	(38)	119
Net operating income	12,047	15,172	13,694
Total operating expenses	(9,092)	(9,358)	(7,991)
Operating profit	2,955	5,814	5,703
Share of profit in associates and joint ventures	528	307	103
Profit before tax	3,483	6,121	5,806
By geographical region			
Europe	195	2,527	2,304
Hong Kong	1,436	1,578	955
Rest of Asia-Pacific	3,786	2,464	1,649
North America	(2,575)	(965)	423
Latin America	641	517	475
	3,483	6,121	5,806
	%	%	%
Share of HSBC's profit before tax	37.4	25.3	26.3
Cost efficiency ratio	67.3	61.5	58.9

For footnotes, see page 143.

Strategic direction

In 2008, Global Banking and Markets continued to pursue its "emerging markets-led and financing-focused" strategy, which was introduced in 2006 and fully implemented in 2007. HSBC's strategy is to be a leading wholesale bank by:

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

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

Financial performance in 2008

- Global Banking and Markets delivered a pre-tax profit of US\$3.5 billion, a decline of US\$2.6 billion or 43 per cent compared with 2007. Although credit trading was significantly impacted by the adverse market conditions, revenues in other core businesses grew strongly in both developed and emerging markets. At constant exchange rates, total operating expenses were slightly below 2007 with a progressive decline over the last four half-years.
- Core businesses such as foreign exchange, Rates, Balance Sheet Management and financing and equity capital markets posted record revenues.
- In 2008, some US\$5.4 billion of write-downs were absorbed on legacy positions in credit trading, leveraged and acquisition financing and monoline credit exposures. This compared with US\$2.1 billion of write-downs recorded in 2007. Results for 2008 included a US\$529 million fair value gain on the widening of credit spreads on structured liabilities.
- In addition, because of an alleged fraud, HSBC wrote off the value of units in funds which had invested with Madoff Securities, and took a charge against trading income of US\$984 million in the equities business in December 2008. The units had been acquired in connection with various financing transactions entered into with institutional clients.

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HSBC HOLDINGS PLC

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

Management view of total operating income

	2008	2007	2006
	US\$m	US\$m	US\$m
Global Markets ¹⁸	2,676	5,720	6,059
Credit	(5,502)	(1,319)	931
Rates	2,033	1,291	1,207
Foreign exchange	3,842	2,178	1,552
Equities	(64)	1,177	721
Securities services	2,116	1,926	1,378
Asset and structured finance	251	467	270
Global Banking	5,718	4,190	3,388
Financing and equity capital markets	3,572	2,186	1,730
Payments and cash management	1,665	1,632	1,257
Other transaction services	481	372	401
Balance Sheet Management	3,618	1,226	713
Global Asset Management	934	1,336	1,061
Principal Investments	(415)	1,253	686
Other ¹⁹	1,066	1,555	1,730
	<hr/>	<hr/>	<hr/>
Total operating income	13,597	15,280	13,637
	<hr/>	<hr/>	<hr/>

*Comparative information has been adjusted to reflect the current management view.**For footnotes, see page 143.*

- Loan impairment charges and other credit risk provisions of US\$1.5 billion were higher than in 2007, reflecting loan impairment charges resulting from the deteriorating credit environment, coupled with a relatively modest impairment charge within the available-for-sale portfolio, taken through the income statement and detailed below.
- Within the Group's available-for-sale portfolio, continuing illiquidity in asset-backed securities markets led to further write-downs. However, due to the underlying credit quality and seniority of the tranches held by HSBC, only a relatively modest impairment charge of US\$279 million was identified on securities with a nominal value of US\$570 million and was taken to the income statement. The expected cash flow impairment on these securities was US\$86 million. A further US\$293 million impairment was absorbed by income note holders who take the first loss on positions within the securities investment conduits (SICs) now consolidated in HSBC's accounts. Further details on the SICs are provided on pages 174 to 179. Business highlights in 2008

The success of Global Banking and Markets' two-year-old 'emerging markets-led and financing-focused' strategy was recognised by a number of key industry awards, including 'Sterling Bond House', 'Islamic Bond House', 'Middle East Loan House' and 'Latin America Bond House' in *International Financing Review*; 'Best Emerging Markets Bank', 'Best Investment Bank in the Middle East' and 'Best Debt House in Europe' in *Euromoney*; 'Best Bond House' in Asia in *FinanceAsia*, *Asiamoney* and *The Asset*; 'Bond House of the Year' in *Latin Finance*; and 'Emerging Markets Manager of the Year' in *European Pensions*.

- In Global Markets, foreign exchange revenues rose by 76 per cent to a record US\$3.8 billion due to increased market volatility and higher levels of customer activity. While foreign exchange revenues rose in all regions, performance was notably strong in Europe, where revenues rose by 75 per cent to US\$1.4 billion, in the Rest of Asia-Pacific region, and in North America, where revenues more than doubled.
- The Rates business also reported record revenues, reflecting increased customer activity against a backdrop of greater market volatility.
- Securities services revenues grew despite the lower interest rate environment, benefiting from new customer flows and additional business from existing customers. Assets under custody decreased by 34 per cent to US\$3.6 trillion, driven by the downturn in the equity markets and the net redemptions experienced across the industry in the final quarter.
- Growth in Global Banking was driven by improved margins in the credit and lending business and substantial gains on credit default swap transactions in certain portfolios. Payments and cash management continued to deliver revenue growth, primarily due to strong growth in liability balances, although margins narrowed in the latter part of the year.
- Balance Sheet Management income rose in Europe, Asia and North America, reflecting positioning ahead of rate reductions by a number of central banks.
- In Principal Investments, markets remained closed for realisations and certain private equity holdings were marked down to reflect market conditions.

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- In Global Asset Management, although underlying management fees remained strong, overall revenues fell, primarily due to the costs associated with the provision of support to certain money market funds. A fall in performance fees reflected a 20 per cent decrease in funds under management following recent equity market declines. Nevertheless, HSBC remained one of the leading emerging markets asset managers.

Reconciliation of reported and underlying profit before tax

2008 compared with 2007

Global Banking and Markets	2007 as reported	2007 acquisitions, disposals & dilution gains ¹	Currency translation ²	2007 at 2008 exchange rates ³	2008 acquisitions and disposals ¹	Underlying change	2008 as reported	Re-reported change	Un
	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m	%	cha
Net interest income	4,430	□	(32)	4,398	□	4,143	8,541	93	
Net fee income	4,901	□	(46)	4,855	□	(564)	4,291	(12)	
Other income ⁴	5,879	□	(57)	5,822	□	(5,136)	686	(88)	
Net operating income⁵	15,210	□	(135)	15,075	□	(1,557)	13,518	(11)	
Loan impairment charges and other credit risk provisions	(38)	□	1	(37)	□	(1,434)	(1,471)	(3,771)	(3)
Net operating income	15,172	□	(134)	15,038	□	(2,991)	12,047	(21)	
Operating expenses	(9,358)	□	175	(9,183)	□	91	(9,092)	3	
Operating profit	5,814	□	41	5,855	□	(2,900)	2,955	(49)	
Income from associates	307	□	18	325	□	203	528	72	
Profit before tax	6,121	□	59	6,180	□	(2,697)	3,483	(43)	

2007 compared with 2006

	2006 as reported	2006 acquisitions and disposals ¹	Currency translation ²	2006 at 2007 exchange rates ⁶	2007 acquisitions, disposals & dilution & gains ¹	Under- lying change	2007 as reported	Re- ported change	Under- lying change
Global Banking and Markets	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m	%	%
Net interest income	3,168	□	175	3,343	25	1,062	4,430	40	32
Net fee income	3,718	□	182	3,900	9	992	4,901	32	25
Other income ⁴	6,689	□	360	7,049	10	(1,180)	5,879	(12)	(17)
Net operating income ⁵	13,575	□	717	14,292	44	874	15,210	12	6
Loan impairment charges and other credit risk provisions	119	□	6	125	□	(163)	(38)	(132)	(130)
Net operating income	13,694	□	723	14,417	44	711	15,172	11	5
Operating expenses	(7,991)	□	(406)	(8,397)	(35)	(926)	(9,358)	(17)	(11)
Operating profit	5,703	□	317	6,020	9	(215)	5,814	2	(4)
Income from associates	103	□	(4)	99	2	206	307	198	208
Profit before tax	5,806	□	313	6,119	11	(9)	6,121	5	□

For footnotes, see page 143.

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)*Customer groups > Global Banking and Markets / Private Banking*Balance sheet data significant to Global Banking and Markets¹⁵**Year ended 31 December 2008**

	Europe US\$m	Hong Kong US\$m	Rest of Asia- Pacific US\$m	North America US\$m	Latin America US\$m	Total US\$m
Trading assets ²⁰	281,089	45,398	19,606	74,498	5,004	425,595
Derivative assets	303,265	26,989	26,506	125,848	5,145	487,753
Loans and advances to:						
□ customers (net)	185,818	23,042	34,590	35,583	8,273	287,306
□ banks (net)	49,508	20,970	26,710	9,238	12,574	119,000
Financial investments ²⁰	105,546	46,964	37,346	39,841	8,179	237,876
Total assets	1,131,721	225,853	172,049	318,139	48,868	1,896,630
Deposits by banks	79,509	11,509	13,205	16,244	3,871	124,338
Customer accounts	199,687	30,866	50,605	23,844	15,384	320,386
Trading liabilities	144,759	13,056	3,687	72,325	2,546	236,373
Derivative liabilities	300,200	28,536	26,481	122,699	4,615	482,531

Year ended 31 December 2007

	Europe	Hong Kong	Rest of Asia- Pacific	North America	Latin America	Total
Trading assets ²⁰	294,078	26,877	19,732	93,395	8,570	442,652
Derivative assets	102,409	11,492	10,234	56,531	1,814	182,480
Loans and advances to:						
□ customers (net)	163,066	19,171	32,106	26,186	9,935	250,464
□ banks (net)	89,651	53,725	30,853	14,938	10,339	199,506
Financial investments ²⁰	94,416	46,765	39,448	33,273	10,155	224,057
Total assets	892,712	215,801	155,106	252,804	45,045	1,561,468
Deposits by banks	85,315	6,251	17,174	14,825	2,830	126,395
Customer accounts	163,713	37,364	54,120	30,732	13,950	299,879
Trading liabilities	201,010	15,939	8,601	73,081	4,998	303,629
Derivative liabilities	104,687	10,865	9,656	53,058	1,986	180,252

Year ended 31 December 2006

	Hong	Rest of Asia-	North	Latin
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	Europe	Kong	Pacific	America	America	Total
Trading assets ²⁰	165,116	30,895	14,726	105,645	7,575	323,957
Derivative assets	53,223	6,259	6,575	32,357	1,230	99,644
Loans and advances to:						
□ customers (net)	140,277	20,270	24,311	17,215	8,147	210,220
□ banks (net)	63,788	45,023	22,171	15,862	9,704	156,548
Financial investments ²⁰	54,009	48,407	20,890	30,496	8,169	161,971
Total assets	526,468	182,540	109,535	203,639	37,564	1,059,746
Deposits by banks	65,963	4,363	9,849	9,664	3,115	92,954
Customer accounts	139,416	24,530	36,623	23,711	11,685	235,965
Trading liabilities	97,015	17,292	6,243	88,275	4,898	213,723
Derivative liabilities	55,581	6,376	6,149	32,148	1,266	101,520

For footnotes, see page 143.

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

Profit before tax

	2008	2007	2006
	US\$m	US\$m	US\$m
Net interest income	1,612	1,216	1,011
Net fee income	1,476	1,615	1,323
Trading income excluding net interest income	408	525	362
Net interest income on trading activities	14	9	2
Net trading income ¹⁶	422	534	364
Net income/(expense) from financial instruments designated at fair value	□	(1)	1
Gains less losses from financial investments	64	119	166
Dividend income	8	7	5
Other operating income	49	58	61
Total operating income	3,631	3,548	2,931
Net insurance claims ¹⁷	□	□	□
Net operating income⁵	3,631	3,548	2,931
Loan impairment charges and other credit risk provisions	(68)	(14)	(33)
Net operating income	3,563	3,534	2,898
Total operating expenses	(2,116)	(2,025)	(1,685)
Operating profit	1,447	1,509	1,213
Share of profit in associates and joint ventures	□	2	1
Profit before tax	1,447	1,511	1,214
By geographical region			
Europe	998	915	805
Hong Kong	237	305	201
Rest of Asia-Pacific	113	92	80
North America	83	174	114
Latin America	16	25	14
	1,447	1,511	1,214
	%	%	%
Share of HSBC's profit before tax	15.6	6.2	5.5
Cost efficiency ratio	58.3	57.1	57.5
Balance sheet data ¹⁵			
	US\$m	US\$m	US\$m
Loans and advances to customers (net)	37,590	43,612	34,297
Total assets	133,216	130,893	106,178

Customer accounts	116,683	106,197	80,303
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For footnotes, see page 143.

Strategic direction

The strategy for Private Banking is to be the world's leading international private bank, known for excellent client experience and global connections.

- HSBC's global network, strong capital position and recognised brand provide a base from which Private Banking attracts and retains clients and serves their complex international needs. It uses both traditional and innovative ways of managing and preserving the wealth of high net worth individuals while optimising returns.
- Private Banking has built a network of domestic and international operations that provide diversified revenue streams, helped by product leadership in areas such as credit, hedge funds, emerging markets, investment advice and estate planning. This is achieved by attracting, retaining and motivating talented individuals, by providing close communication between clients and staff, and by making targeted investments in IT, marketing and branding initiatives.

Financial performance in 2008

- Reported pre-tax profit fell by 4 per cent as clients moved progressively to a more conservative investment stance in the turbulent markets. This trend was reflected in reduced trading income in Asia, lower fee income in Europe and higher loan impairment charges and other credit risk provisions. By contrast, net interest income grew strongly in Europe. On an underlying basis, pre-tax profit decreased by 3 per cent.
- Net interest income rose by 34 per cent to US\$1.6 billion as a result of an increase in customer deposit balances in Switzerland, the UK and Hong Kong as customers reduced risk in response to market turbulence, choosing HSBC for its strength and switching from investment securities to cash deposits. Spreads improved as interest rates declined sharply.
- Net fee income decreased by 4 per cent to US\$1.5 billion, driven by a fall in funds under management in all regions as a result of equity market declines and clients switching from securities into cash deposits. Transaction volumes also fell, particularly in the fourth quarter.

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)*Customer groups > Private Banking*

- Trading income fell by 21 per cent to US\$422 million, driven by lower demand for structured products in Asia following the decline in the Hong Kong stock market which led to clients preferring more stable cash deposits. Partly offsetting this was an increase in foreign exchange trading revenue in the volatile currency markets.
- Gains less losses from financial investments decreased by 47 per cent to US\$64 million due to lower gains from the disposal of HSBC's residual holding in the Hermitage Fund in 2008, compared with 2007.
- Loan impairment charges and other credit risk provisions increased by US\$54 million to US\$68 million, primarily due to a loss on a bond position in a failed US bank and higher provisions on real estate-related products.
- Operating expenses grew by 9 per cent to US\$2.1 billion, mainly due to the non-recurrence of a one-off pension-related credit recognised in 2007. Staff numbers increased in Asia and Europe in late 2007 and the first half of 2008, leading to higher costs, although these reduced in the second half of the year. As a result, the cost efficiency ratio worsened by 1.9 percentage points to 58.3 per cent.

Client assets

	2008	2007
	US\$bn	US\$bn
At 1 January	421	333
Net new money	24	36
Value change	(71)	19
Exchange and other	(22)	33
	<hr/>	<hr/>
At 31 December	352	421
	<hr/>	<hr/>

Client assets by investment class

	2008	2007
	US\$bn	US\$bn
Equities	53	81
Bonds	57	64
Structured products	7	12
Funds	87	123
Cash, fiduciary deposits and other	148	141
	<hr/>	<hr/>
	352	421

- Reported client assets decreased by 16 per cent to US\$352 billion in 2008, due to the decline in equity market values in all regions. Net new money flows continued to be strong, particularly in Europe, as clients were attracted by HSBC's strong capital base during the market turbulence. However, reduced leverage had a US\$5.9 billion effect on net new money flows compared with 2007 and some outflows of client deposits were experienced in the fourth quarter following the introduction of government guarantees to certain competitor banks.
- Total client assets declined by 12 per cent on a reported basis to US\$433 billion, with net new money of US\$30 billion. Total client assets is a measure equivalent to many industry definitions of assets under management which include some non-financial assets held in client trusts.

Business highlights in 2008

- Inward referrals from other customer groups in HSBC resulted in US\$6.8 billion of net new money compared with US\$5.7 billion in 2007.
- The proportion of trading volumes that were transacted with Global Banking and Markets increased as more systems and processes were connected.
- Investments in emerging markets continued as Private Banking clients invested over US\$1 billion in various HSBC Private Equity and fund offerings.
- The *Euromoney* 2009 Private Banking Survey placed HSBC Private Bank second overall in the Global Private Bank category, up from third in 2008. HSBC Private Bank was also awarded Best Private Bank in Asia and Best Private Bank in the Middle East. At the International Wealth Management Summit, HSBC won Outstanding Global Private Banker awarded to the Global CEO of HSBC Private Bank, and Outstanding Private Bank in the Middle East.
- In 2008, HSBC announced that it would merge its two Swiss private banks under the HSBC Private Bank brand. The merger is expected to result in future strategic and cost benefits.
- Following a comprehensive review in 2008, HSBC Private Bank launched a fresh image campaign in 2009, including the aim to be The world's private bank in alignment with the Group's recognised global brand strategy. The launch was combined with a targeted advertising and marketing campaign.
- Offices in Guangzhou, Shanghai and Beijing were formally opened as part of the launch of Private Banking operations in mainland China. Preparations were also made for a launch of domestic operations in Russia in 2009.

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Reconciliation of reported and underlying profit before tax

**2008 compared with
2007**

	2007 as reported	2007 acquisitions, disposals & dilution gains¹	Currency translation²	2007 at 2008 exchange rates³	2008 acquisitions and disposals¹	Underlying change	2008 as reported	Report chan
Private Banking	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m	
Net interest income	1,216	1	(12)	1,205	□	407	1,612	
Net fee income	1,615	(105)	26	1,536	□	(60)	1,476	
Other income ⁴	717	(18)	5	704	□	(161)	543	(3)
Net operating income⁵	3,548	(122)	19	3,445	□	186	3,631	
Loan impairment charges and other credit risk provisions	(14)	□	□	(14)	□	(54)	(68)	(3)
Net operating income	3,534	(122)	19	3,431	□	132	3,563	
Operating expenses	(2,025)	98	(17)	(1,944)	□	(172)	(2,116)	
Operating profit	1,509	(24)	2	1,487	□	(40)	1,447	
Income from associates	2	□	□	2	□	(2)	□	(1)
Profit before tax	1,511	(24)	2	1,489	□	(42)	1,447	

2007 compared with 2006

	2006 as reported	2006 acquisitions and disposals¹	Currency translation²	2006 at 2007 exchange rates⁶	2007 acquisitions, disposals & dilution gains¹	Underlying change	2007 as reported	Reported change
Private Banking	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m	%

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Net interest income	1,011	□	24	1,035	2	179	1,216	20
Net fee income	1,323	□	32	1,355	4	256	1,615	22
Other income ⁴	597	□	7	604	1	112	717	20
Net operating income ⁵	2,931	□	63	2,994	7	547	3,548	21
Loan impairment charges and other credit risk provisions	(33)	□	□	(33)	□	19	(14)	58
Net operating income	2,898	□	63	2,961	7	566	3,534	22
Operating expenses	(1,685)	□	(40)	(1,725)	(4)	(296)	(2,025)	(20)
Operating profit	1,213	□	23	1,236	3	270	1,509	24
Income from associates	1	□	□	1	□	1	2	100
Profit before tax	1,214	□	23	1,237	3	271	1,511	24

For footnotes, see page 143.

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HSBC HOLDINGS PLC

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

Profit/(loss) before tax

	2008	2007	2006
	US\$m	US\$m	US\$m
Net interest expense	(956)	(542)	(625)
Net fee income/(expense)	53	(228)	172
Trading income/(expense) excluding net interest income	(262)	127	(228)
Net interest income/(expense) on trading activities	(268)	(1)	82
Net trading income/(expense) ¹⁶	(530)	126	(146)
Changes in fair value of long-term debt issued and related derivatives	6,679	2,812	(35)
Net income/(expense) from other financial instruments designated at fair value	747	81	(46)
Net income/(expense) from financial instruments designated at fair value	7,426	2,893	(81)
Gains less losses from financial investments	(396)	83	147
Gains arising from dilution of interests in associates	□	1,092	□
Dividend income	10	32	63
Net earned insurance premiums	(17)	(21)	207
Gains on disposal of French regional banks	2,445	□	□
Other operating income	4,261	3,523	3,254
Total operating income	12,296	6,958	2,991
Net insurance claims ¹⁷	(1)	□	(181)
Net operating income⁵	12,295	6,958	2,810
Loan impairment charges and other credit risk provisions	(5)	(11)	(13)
Net operating income	12,290	6,947	2,797
Total operating expenses	(4,174)	(3,562)	(3,259)
Operating profit/(loss)	8,116	3,385	(462)
Share of profit in joint ventures and associates	41	150	74
Profit/(loss) before tax	8,157	3,535	(388)
By geographical region			
Europe	5,296	1,056	(278)
Hong Kong	(955)	(375)	(175)
Rest of Asia-Pacific	276	1,343	287

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North America	3,534	1,508	(217)
Latin America	6	3	(5)
	8,157	3,535	(388)
	%	%	%
Share of HSBC's profit before tax	87.6	14.6	(1.8)
Cost efficiency ratio	33.9	51.2	116.0

For footnotes, see page 143.

Notes

- Reported profit before tax in Other was US\$8.2 billion, compared with US\$3.5 billion in 2007. For a description of the main items reported under "Other", see footnote 14 on page 143.
- Net income from financial instruments designated at fair value amounted to US\$7.4 billion in 2008, compared with US\$2.9 billion in 2007. This largely related to fair value gains on own debt issued by HSBC Holdings and its North American and European subsidiaries and resulted primarily from the widening of credit spreads. These gains will reverse over the life of the debt.
- A loss of US\$396 million reported in "Gains less losses from financial investments" included impairments related to non-trading strategic equity investments, classified as available for sale, following significant declines in equity market prices. These investments were primarily in Asian financial services companies which are held for the long term.
- In 2007, the results included dilution gains of US\$1.1 billion following share offerings made by HSBC's associates, Ping An Insurance, Bank of Communications and Industrial Bank in mainland China, Financiera Independencia in Mexico and Techcombank in Vietnam.
- Other gains included a US\$2.4 billion pre-tax profit from the sale of seven regional banks in France.
- HSBC recognised a gain of US\$416 million in respect of the purchase of the subsidiary of Metrovacesa which owned the property and long leasehold land comprising 8 Canada Square, London. See Note 23 on the Financial Statements for further details.
- HSBC continued to increase the scope of activities undertaken at its Group Service Centres ("GSCs") which are accounted for within Other. Employee numbers increased accordingly and an additional GSC was opened which, together, contributed to a rise in operating expenses. In North America, costs at the IT Service Centres declined in line with reduced operations in the region. Substantially all service centre costs are recharged to HSBC's customer groups and reported under "Other operating income".

[Back to Contents](#)Balance sheet data¹⁵

	2008	2007	2006
	US\$m	US\$m	US\$m
Loans and advances to customers (net)	2,621	2,678	2,095
Total assets	135,001	155,685	137,291
Customer accounts	2,041	2,006	1,245

Reconciliation of reported and underlying profit/(loss) before tax

Other	2008 compared with 2007							Reported change
	2007 as reported US\$m	2007 acquisitions, disposals & dilution gains ¹ US\$m	Currency translation ² US\$m	2007 at 2008 exchange rates ³ US\$m	2008 acquisitions and disposals ¹ US\$m	Underlying change US\$m	2008 as reported US\$m	
Net interest expense (Net fee income/(expense))	(542)	□	(38)	(580)	(6)	(370)	(956)	(1,000)
Other income ⁴	7,728	(1,116)	36	6,648	2,540	4,010	13,198	13,198
Net operating income⁵	6,958	(1,116)	47	5,889	2,534	3,872	12,295	12,295
Loan impairment charges and other credit risk provisions	(11)	24	1	14	□	(19)	(5)	5
Net operating income	6,947	(1,092)	48	5,903	2,534	3,853	12,290	12,290
Operating expenses	(3,562)	□	(15)	(3,577)	6	(603)	(4,174)	(4,174)
Operating profit	3,385	(1,092)	33	2,326	2,540	3,250	8,116	8,116
Income from associates	150	(12)	11	149	□	(108)	41	(41)

Profit before tax	3,535	(1,104)	44	2,475	2,540	3,142	8,157	1,011
2007 compared with 2006								
	2006 as reported US\$m	2006 acquisitions and disposals ¹ US\$m	Currency translation ² US\$m	2006, at 2007 exchange rates ⁶ US\$m	2007 acquisitions disposals & dilution gains ¹ US\$m	Underlying change US\$m	2007 as reported US\$m	Reported change %
Other								
Net interest income	(625)	□	(22)	(647)	□	105	(542)	13
Net fee income	172	□	25	197	□	(425)	(228)	(233)
Other income ⁴	3,263	□	77	3,340	1,092	3,296	7,728	137
Net operating income ⁵	2,810	□	80	2,890	1,092	2,976	6,958	148
Loan impairment charges and other credit risk provisions	(13)	□	3	(10)	□	(1)	(11)	15
Net operating income	2,797	□	83	2,880	1,092	2,975	6,947	148
Operating expenses	(3,259)	□	(90)	(3,349)	□	(213)	(3,562)	(9)
Operating profit/(loss)	(462)	□	(7)	(469)	1,092	2,762	3,385	833
Income from associates	74	□	2	76	(50)	124	150	103
Profit/(loss) before tax	(388)	□	(5)	(393)	1,042	2,886	3,535	1,011

For footnotes, see page 143.

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HSBC HOLDINGS PLC

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

Customer groups > Profit/(loss) before tax

Analysis by customer group and global business

Profit/(loss) before tax

	2008						
Total	Personal Financial Services US\$m	Commercial Banking US\$m	Global Banking & Markets US\$m	Private Banking US\$m	Other¹⁴ US\$m	Inter- segment elimination²¹ US\$m	Total US\$m
Net interest income/(expense)	29,419	9,494	8,541	1,612	(956)	(5,547)	42,563
Net fee income	10,107	4,097	4,291	1,476	53	□	20,024
Trading income/(expense) excluding net interest income	175	369	157	408	(262)	□	847
Net interest income/(expense) on trading activities	79	17	324	14	(268)	5,547	5,713
Net trading income/(expense) ¹⁶	254	386	481	422	(530)	5,547	6,560
Changes in fair value of long-term debt issued and related derivatives	□	□	□	□	6,679	□	6,679
Net income/(expense) from other financial instruments designated at fair value	(2,912)	(224)	(438)	□	747	□	(2,827)
Net income/(expense) from financial instruments designated at fair value	(2,912)	(224)	(438)	□	7,426	□	3,852
Gains less losses from financial investments	663	193	(327)	64	(396)	□	197
Dividend income	90	88	76	8	10	□	272
Net earned insurance premiums	10,083	679	105	□	(17)	□	10,850
Gains on disposal of French regional banks	□	□	□	□	2,445	□	2,445

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Other operating income	259	939	868	49	4,261	(4,568)	1,808
Total operating income	47,963	15,652	13,597	3,631	12,296	(4,568)	88,571
Net insurance claims ¹⁷	(6,474)	(335)	(79)	□	(1)	□	(6,889)
Net operating income⁵	41,489	15,317	13,518	3,631	12,295	(4,568)	81,682
Loan impairment charges and other credit risk provisions	(21,220)	(2,173)	(1,471)	(68)	(5)	□	(24,937)
Net operating income	20,269	13,144	12,047	3,563	12,290	(4,568)	56,745
Operating expenses (excluding goodwill impairment)	(21,140)	(6,581)	(9,092)	(2,116)	(4,174)	4,568	(38,535)
Goodwill impairment	(10,564)	□	□	□	□	□	(10,564)
Operating profit/(loss)	(11,435)	6,563	2,955	1,447	8,116	□	7,646
Share of profit in associates and joint ventures	461	631	528	□	41	□	1,661
Profit/(loss) before tax	(10,974)	7,194	3,483	1,447	8,157	□	9,307
	%	%	%	%	%		%
Share of HSBC's profit before tax	(117.9)	77.3	37.4	15.6	87.6		100.0
Cost efficiency ratio	76.4	43.0	67.3	58.3	33.9		60.1
Balance sheet data¹⁵	US\$m	US\$m	US\$m	US\$m	US\$m		US\$m
Loans and advances to customers (net)	401,402	203,949	287,306	37,590	2,621		932,868
Total assets	514,419	249,218	1,896,630	133,216	135,001	(401,019)	2,527,465
Customer accounts	440,338	235,879	320,386	116,683	2,041		1,115,327

For footnotes, see page 143.

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2007

Total	Personal Financial Services US\$m	Commercial Banking US\$m	Global Banking & Markets US\$m	Private Banking US\$m	Other ¹⁴ US\$m	Inter- segment elimination ²¹ US\$m	Total US\$m
Net interest income/(expense)	29,069	9,055	4,430	1,216	(542)	(5,433)	37,795
Net fee income/(expense)	11,742	3,972	4,901	1,615	(228)	□	22,002
Trading income excluding net interest income	38	265	3,503	525	127	□	4,458
Net interest income/(expense) on trading activities	140	31	(236)	9	(1)	5,433	5,376
Net trading income ¹⁶	178	296	3,267	534	126	5,433	9,834
Changes in fair value of long-term debt issued and related derivatives	□	□	□	□	2,812	□	2,812
Net income/(expense) from other financial instruments designated at fair value	1,333	22	(164)	(1)	81	□	1,271
Net income/(expense) from financial instruments designated at fair value	1,333	22	(164)	(1)	2,893	□	4,083
Gains less losses from financial investments	351	90	1,313	119	83	□	1,956
Gains arising from dilution of interests in associates	□	□	□	□	1,092	□	1,092
Dividend income	55	8	222	7	32	□	324
Net earned insurance premiums	8,271	733	93	□	(21)	□	9,076
Other operating income	387	165	1,218	58	3,523	(3,912)	1,439
Total operating income	51,386	14,341	15,280	3,548	6,958	(3,912)	87,601
Net insurance claims ¹⁷	(8,147)	(391)	(70)	□	□	□	(8,608)

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Net operating income⁵	43,239	13,950	15,210	3,548	6,958	(3,912)	78,993
Loan impairment charges and other credit risk provisions	(16,172)	(1,007)	(38)	(14)	(11)	□	(17,242)
Net operating income	27,067	12,943	15,172	3,534	6,947	(3,912)	61,751
Total operating expenses	(21,757)	(6,252)	(9,358)	(2,025)	(3,562)	3,912	(39,042)
Operating profit	5,310	6,691	5,814	1,509	3,385	□	22,709
Share of profit in associates and joint ventures	590	454	307	2	150	□	1,503
Profit before tax	5,900	7,145	6,121	1,511	3,535	□	24,212
	%	%	%	%	%		%
Share of HSBC's profit before tax	24.4	29.5	25.3	6.2	14.6		100.0
Cost efficiency ratio	50.3	44.8	61.5	57.1	51.2		49.4
	US\$m	US\$m	US\$m	US\$m	US\$m		US\$m
Balance sheet data¹⁵							
Loans and advances to customers (net)	464,726	220,068	250,464	43,612	2,678		981,548
Total assets	621,356	307,944	1,561,468	130,893	155,685	(423,080)	2,354,266
Customer accounts	450,071	237,987	299,879	106,197	2,006		1,096,140

For footnotes, see page 143.

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HSBC HOLDINGS PLC

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

Customer groups > Profit/(loss) before tax // Geographical regions > Summary

Profit/(loss) before tax (continued)

Total	2006						Total US\$m
	Personal Financial Services US\$m	Commercial Banking US\$m	Global Banking & Markets US\$m	Private Banking US\$m	Other ¹⁴ US\$m	Inter- segment elimination ²¹ 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) ¹⁶	611	224	4,511	364	(146)	2,658	8,222
Changes in fair value of long-term debt issued and related derivatives	□	□	□	□	(35)	□	(35)
Net income/(expense) from other financial instruments designated at fair value	739	(22)	20	1	(46)	□	692
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
	42,209	11,481	13,637	2,931	2,991	(3,179)	70,070

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Total operating income							
Net insurance claims ¹⁷	(4,365)	(96)	(62)	□	(181)	□	(4,704)
Net operating income ⁵	37,844	11,385	13,575	2,931	2,810	(3,179)	65,366
Loan impairment (charges)/recoveries and other credit risk provisions	(9,949)	(697)	119	(33)	(13)	□	(10,573)
Net operating income	27,895	10,688	13,694	2,898	2,797	(3,179)	54,793
Total operating expenses	(18,818)	(4,979)	(7,991)	(1,685)	(3,259)	3,179	(33,553)
Operating profit/(loss)	9,077	5,709	5,703	1,213	(462)	□	21,240
Share of profit in associates and joint ventures	380	288	103	1	74	□	846
Profit/(loss) before tax	9,457	5,997	5,806	1,214	(388)	□	22,086
	%	%	%	%	%		%
Share of HSBC's profit before tax	42.8	27.2	26.3	5.5	(1.8)		100.0
Cost efficiency ratio	49.7	43.7	58.9	57.5	116.0		51.3
	US\$m	US\$m	US\$m	US\$m	US\$m		US\$m
Balance sheet data ¹⁵							
Loans and advances to customers (net)	448,545	172,976	210,220	34,297	2,095		868,133
Total assets	602,342	228,668	1,059,746	106,178	137,291	(273,467)	1,860,758
Customer accounts	388,468	190,853	235,965	80,303	1,245		896,834

For footnotes, see page 143.

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Geographical regions

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Additional information on results in 2008 may be found in the "Financial Summary" on pages 23 to 38.

Summary

Europe

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

Hong Kong

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

Rest of Asia-Pacific (including the Middle East)

HSBC offers personal, commercial, global banking and markets services in mainland China, mainly through its local subsidiary, HSBC Bank (China) Company Limited ("HSBC Bank China"). HSBC also participates indirectly in mainland China through its three associates, Bank of Communications (19.01 per cent owned), Ping An Insurance (16.78 per cent) and Industrial Bank (12.78 per cent), and has a further interest of 8 per cent in Bank of Shanghai.

Outside Hong Kong and mainland China, HSBC conducts business in 20 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, together with HSBC's subsidiaries and associates, gives it the widest coverage in the region; in Australia by HSBC Bank Australia Limited; and in Malaysia by HSBC Bank Malaysia Berhad ("HSBC Bank Malaysia"), which is the largest foreign-owned bank in the country by operating income and pre-tax profits. HSBC's associate in Saudi Arabia, The Saudi British Bank (40 per cent owned), is the Kingdom's fifth 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 the Chicago metropolitan area. HSBC Markets (USA) Inc. is the intermediate holding company of, *inter alia*, HSBC Securities (USA) Inc., a registered

broker and dealer of securities and a registered futures commission merchant. HSBC Bank Canada and The Bank of Bermuda Limited (["Bank of Bermuda"]) operate in their respective countries.

Latin America

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

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)*Geographical regions > Summary / Europe*

In the analysis of profit by geographical regions that follows, operating income and operating expenses include intra-HSBC items of US\$2,492 million (2007: US\$1,985 million; 2006: US\$1,494 million).

Profit/(loss) before tax

	2008		2007		2006	
	US\$m	%	US\$m	%	US\$m	%
Europe	10,869	116.7	8,595	35.5	6,974	31.5
Hong Kong	5,461	58.7	7,339	30.3	5,182	23.5
Rest of Asia-Pacific	6,468	69.5	6,009	24.8	3,527	16.0
North America	(15,528)	(166.8)	91	0.4	4,668	21.1
Latin America	2,037	21.9	2,178	9.0	1,735	7.9
	9,307	100.0	24,212	100.0	22,086	100.0

Total assets¹⁵

At 31 December

	2008		2007	
	US\$m	%	US\$m	%
Europe	1,343,011	53.1	1,236,633	52.5
Hong Kong	407,151	16.1	356,894	15.2
Rest of Asia-Pacific	262,305	10.4	243,205	10.3
North America	552,612	21.9	549,285	23.3
Latin America	97,944	3.9	101,088	4.3
Intra-HSBC items	(135,558)	(5.4)	(132,839)	(5.6)
	2,527,465	100.0	2,354,266	100.0

For footnote, see page 143.

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

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

	Personal Financial Services US\$m	Commercial Banking US\$m	Global Banking & Markets²¹ US\$m	Private Banking US\$m	Other US\$m	Total US\$m
2008						
United Kingdom	1,546	2,361	(469)	250	2,997	6,685
France ²²	139	176	273	10	2,242	2,840
Germany	□	31	184	32	(22)	225
Malta	59	67	16	□	□	142
Switzerland	□	□	□	553	□	553
Turkey	3	91	130	□	□	224
Other	(89)	(4)	61	153	79	200
	1,658	2,722	195	998	5,296	10,869
2007						
United Kingdom	1,221	2,064	1,214	317	976	5,792
France ²²	173	192	692	25	(49)	1,033
Germany	□	36	195	45	19	295
Malta	45	67	45	□	□	157
Switzerland	□	□	□	475	□	475
Turkey	144	75	118	(1)	□	336
Other	(2)	82	263	54	110	507
	1,581	2,516	2,527	915	1,056	8,595
2006						
United Kingdom	1,496	1,801	1,299	380	(185)	4,791
France ²²	174	236	545	22	(107)	870
Germany	□	29	114	41	16	200
Malta	42	50	29	□	□	121
Switzerland	□	□	□	305	□	305
Turkey	121	50	64	□	(18)	217
Other	76	68	253	57	16	470
	1,909	2,234	2,304	805	(278)	6,974

Loans and advances to customers (net) by country

At 31 December

2008 US\$m	2007 US\$m	2006 US\$m
-----------------------	---------------	---------------

United Kingdom	313,065	326,927	305,758
France ²²	70,896	81,473	55,491
Germany	5,756	6,411	4,439
Malta	4,343	4,157	3,456
Switzerland	12,708	13,789	9,151
Turkey	6,125	7,974	5,233
Other	13,298	11,544	8,971
	426,191	452,275	392,499

Customer accounts by country

At 31 December

	2008	2007	2006
	US\$m	US\$m	US\$m
United Kingdom	351,253	367,363	318,614
France ²²	74,826	64,905	43,372
Germany	11,611	10,282	11,607
Malta	5,604	5,947	4,529
Switzerland	44,643	41,015	30,062
Turkey	5,845	6,473	4,140
Other	8,694	8,969	7,041
	502,476	504,954	419,365

For footnotes, see page 143.

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)*Geographical regions > Europe > 2008*

Profit before tax

	2008	2007	2006
Europe	US\$m	US\$m	US\$m
Net interest income	9,696	7,746	8,289
Net fee income	7,492	8,431	7,108
Net trading income	5,357	6,943	4,529
Changes in fair value of long-term debt issued and related derivatives	2,939	1,059	28
Net income/(expense) from other financial instruments designated at fair value	(1,826)	167	116
Net income from financial instruments designated at fair value	1,113	1,226	144
Gains less losses from financial investments	418	1,326	624
Dividend income	130	171	183
Net earned insurance premiums	5,299	4,010	1,298
Gains on disposal of French regional banks	2,445	□	□
Other operating income	2,096	1,193	1,428
Total operating income	34,046	31,046	23,603
Net insurance claims incurred and movement in liabilities to policyholders	(3,367)	(3,479)	(531)
Net operating income before loan impairment charges and other credit risk provisions	30,679	27,567	23,072
Loan impairment charges and other credit risk provisions	(3,754)	(2,542)	(2,155)
Net operating income	26,925	25,025	20,917
Total operating expenses	(16,072)	(16,525)	(13,871)
Operating profit	10,853	8,500	7,046
Share of profit/(loss) in associates and joint ventures	16	95	(72)
Profit before tax	10,869	8,595	6,974
	%	%	%
Share of HSBC's profit before tax	116.7	35.5	31.5
Cost efficiency ratio	52.4	59.9	60.1
Year-end staff numbers (full-time equivalent)	82,093	82,166	78,311

Balance sheet data¹⁵

At 31 December

2008	2007	2006
-------------	------	------

	US\$m	US\$m	US\$m
Loans and advances to customers (net)	426,191	452,275	392,499
Loans and advances to banks (net)	61,949	104,527	76,830
Trading assets, financial assets designated at fair value and financial investments ²⁰	433,885	445,258	242,010
Total assets	1,343,011	1,236,633	867,032
Deposits by banks	80,847	87,491	67,821
Customer accounts	502,476	504,954	419,365

For footnotes, see page 143.

All commentaries on Europe are on an underlying basis unless stated otherwise.

2008 compared with 2007

Economic briefing

In the **UK**, growth in gross domestic product (□GDP□) decelerated markedly in 2008 to 0.7 per cent from 3.0 per cent in 2007, with a technical recession of two successive quarterly contractions in GDP confirmed during the second half of the year. Weakness proved widespread across most of the

economy, prompting a sharp deterioration in labour market conditions as unemployment hit a 9-year high of 6.1 per cent in November 2008. Consumer Price Index (□CPI□) inflation reached a decade-long high of 5.2 per cent in September 2008 before falling back to 3.1 per cent by the year-end, still some way above the Bank of England's 2 per cent target. House prices continued to fall throughout the year and housing activity decreased sharply. The Bank of

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England reduced interest rates by 350 basis points during 2008, to finish the year at 2 per cent, as policymakers sought to mitigate the worst effects of the economic slowdown.

The expansion of the **eurozone** economy slowed sharply in 2008, with GDP growth of 0.7 per cent following a 2.6 per cent expansion in 2007. As in the UK, conditions deteriorated markedly as the year progressed and three successive quarterly declines in GDP were recorded during 2008, confirming that the economy had entered a period

of recession. Consumer spending growth proved subdued following the sharp rise in oil prices during the first of half of 2008 and a progressive increase in the unemployment rate towards the year-end. Inflation remained a concern for much of 2008, hitting a peak of 4.0 per cent in July before falling rapidly to 1.6 per cent in December. The European Central Bank, having initially raised interest rates by 25 basis points in July, cut them by 175 basis points to finish the year at 2.5 per cent.

Reconciliation of reported and underlying profit before tax

2008 compared with 2007

	2007 as reported US\$m	2007 acquisitions, disposals & dilution gains ¹ US\$m	Currency translation ² US\$m	2007 at 2008 exchange rates ³ US\$m	2008 acquisitions and disposals ¹ US\$m	Underlying change US\$m	2008 as reported US\$m	Reported change %
Europe								
Net interest income	7,746	(390)	(224)	7,132	219	2,345	9,696	25
Net fee income	8,431	(134)	(244)	8,053	15	(576)	7,492	(11)
Other income ⁴	11,390	(121)	(380)	10,889	3,007	(405)	13,491	18
Net operating income⁵	27,567	(645)	(848)	26,074	3,241	1,364	30,679	11
Loan impairment charges and other credit risk provisions	(2,542)	30	152	(2,360)	(6)	(1,388)	(3,754)	(48)
Net operating income	25,025	(615)	(696)	23,714	3,235	(24)	26,925	8
Operating expenses	(16,525)	416	531	(15,578)	(88)	(406)	(16,072)	3
Operating profit	8,500	(199)	(165)	8,136	3,147	(430)	10,853	28
Income from	95	(12)	14	97	□	(81)	16	(83)

associates

Profit before tax	8,595	(211)	(151)	8,233	3,147	(511)	10,869	26
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For footnotes, see page 143.

Review of business performance

HSBC's European operations reported a pre-tax profit of US\$10.9 billion, compared with US\$8.6 billion in 2007, an increase of 26 per cent.

These results included gains of US\$2.4 billion on the disposal of seven regional banks in France in July 2008, and of US\$425 million on the sale of the card acquiring business in the UK to a joint venture with Global Payments, Inc. in June 2008. Excluding these disposals and, in 2007, the acquisition of HSBC Assurances and the disposal of Hamilton Insurance Company Limited and Hamilton Life Assurance Company Limited and substantial fair value gains on own debt, underlying pre-tax profits fell by 33 per cent. This primarily reflected a sharp decline in Global Banking and Markets' revenues, which was mainly attributable to the deterioration in credit markets, the continuing illiquidity in asset-backed securities markets which led to further

write-downs, and a US\$854 million charge within the equities business following the alleged fraud at Madoff Securities. Personal Financial Services and Private Banking delivered underlying growth.

Net interest income increased by 33 per cent. There was significant growth in Balance Sheet Management revenues, which reflected favourable interest rate risk positioning in expectation of interest rate cuts by central banks. Net interest income also benefited from necessarily selective incremental lending as credit availability generally contracted. In Global Banking, net interest income was boosted by improved spreads.

Falling confidence in the UK banking sector necessitated government intervention in a number of competitor banks. HSBC experienced a strong increase in customer numbers, with corresponding growth in liability balances as the market turmoil intensified. The volume benefit was partially offset

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)*Geographical regions > Europe > 2008 / 2007*

by narrowing deposit spreads, as base rates were cut in the UK, and increased funding costs, principally for trading activities, in France. Higher net interest income from the expansion of credit card lending and commercial loan portfolio growth in the small and mid-market customer segments in Turkey was partially offset by narrower spreads following credit card interest rate cap reductions by the central bank.

Net fee income fell by 7 per cent, with lower fees from mergers and acquisitions and equity capital markets due to origination and execution difficulties, coupled with a rise in brokerage expenses in line with increased trading activity in France. Lower performance and management fees in the UK and France as the value of funds under management reduced, reflected the decline in global equity markets. Increased customer acquisition partly offset this, with higher fees derived from growth in packaged accounts and transaction volumes in France and credit card fees in Turkey.

Trading income was 20 per cent lower than in 2007, falling significantly in Global Banking and Markets due to further write-downs on legacy exposures in credit, structured credit derivatives and leveraged and acquisition finance caused by the ongoing turmoil in the credit markets. In addition, a US\$854 million charge was taken in equities in respect of the alleged fraud at Madoff Securities. US\$11.4 billion and US\$2.4 billion of held-for-trading financial assets were reclassified under revised IFRS rules as loans and receivables and available for sale, respectively, preventing any further mark-to-market trading losses on these assets. If these reclassifications had not been made, the profit before tax would have been US\$2.6 billion lower.

Excluding the write-downs on legacy exposures and the charge relating to Madoff Securities, trading income grew by 11 per cent, driven by a significant increase in foreign exchange revenues against the backdrop of greater market volatility, and robust revenues in the Rates business, which was positioned to take advantage of falling interest rates. The widening of credit spreads, particularly in the second half of 2008, contributed to fair value gains on structured liabilities and on credit protection bought in the form of credit default swaps.

Net income from financial instruments designated at fair value increased by 36 per cent, primarily due to fair value gains from the effect of widening credit spreads on certain fixed-rate long-term debt issued by HSBC Holdings. This movement was partly offset by a reduction in the value of assets held to meet liabilities under insurance and

investment contracts. The reduction in fair value of assets held to meet liabilities under unit-linked insurance contracts is offset by a corresponding reduction in [Net insurance claims and liabilities to policyholders]. The fair value gains on HSBC's own debt will fully reverse over the life of the debt.

Gains less losses from financial investments of US\$418 million were US\$915 million lower than in 2007 as there were fewer disposal opportunities in 2008 and the significant realisations from equity investments in the UK and France in 2007 did not recur. Gains largely reflected the sale of MasterCard shares in 2008.

Net earned insurance premiums increased by 22 per cent, largely due to growth in the Guaranteed Income Bond launched in June 2007 and the introduction of enhanced death benefits to certain pension products in the UK. In France, HSBC Assurances performed well in a declining market, as the launch of new guaranteed rate products contributed to 3 per cent growth in gross earned premiums. However, net earned insurance premiums fell following a significant re-insurance transaction undertaken in the first half of 2008.

Other operating income increased by 33 per cent. This was primarily due to recognition of the gain in respect of the purchase of the subsidiary of Metrovacesa which owned the property and long leasehold land comprising 8 Canada Square, London. See Note 23 on the Financial Statements for further details. The growth in revenue also reflected the non-recurrence of a decrease in the value of PVIF business in 2007 following regulatory changes to the rules governing the calculation of insurance liabilities. In addition, there was a favourable embedded value adjustment following HSBC's introduction of enhanced benefits to existing commercial pension products in the first half of 2008. These benefits were partially offset by costs associated with the support of money market funds in the global asset management business.

Net insurance claims incurred and movement in liabilities to policyholders decreased by 5 per cent as a reduction in insurance liabilities reflected the fall in value of market-linked funds. This was partially offset by an increase in liabilities following increased sales of the Guaranteed Income Bond and the implementation of FSA rule changes in 2007 which lowered the liability valuation on life policies.

Loan impairment charges and credit risk provisions rose by 59 per cent to US\$3.8 billion; in the UK, primarily in Global Banking and Markets. The deteriorating credit environment resulted in a rise in loan impairment charges, largely reflecting an

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exposure to a single European property company, and additional credit risk provisions on debt securities held within the Group's available-for-sale portfolio, mainly in Solitaire Funding Limited (["Solitaire"]), a special purpose entity managed by HSBC. A modest improvement in the UK personal finance sector reflected the non-recurrence of a change in the methodology in the consumer finance business which resulted in a higher charge in 2007. Excluding this factor, delinquency rates in cards were marginally higher and there was a rise in impairments in the consumer finance business driven by worsening economic conditions and credit quality deterioration, partly offset by action taken to mitigate risk through the continued application of strict lending criteria and the sale of non-core credit card portfolios.

Credit conditions weakened in the commercial business and specific loan impairment charges increased in the UK and France due to the deteriorating credit environment in the second half of 2008. In Turkey, credit card and personal loan delinquency rates were significantly higher, resulting in the implementation of tighter underwriting criteria, reduced credit limits and revised account management policies throughout 2008.

Operating costs increased by 3 per cent to US\$16.1 billion. Costs in the UK were in line with 2007, which included ex-gratia payments expensed in respect of overdraft fees applied in previous years and a provision for reimbursement of certain charges on historic will trusts and other related services. Excluding these items, costs rose as a result of an increase in the Financial Services Compensation Scheme levy, restructuring costs and increased rental charges following the sale and leaseback of branch properties, partially offset by lower performance-related pay and a reduction in defined benefit pension scheme costs due to a change in actuarial assumptions.

Operating costs in France decreased slightly with lower performance-related pay and a reduction in pension and retirement healthcare costs following the transfer of certain obligations to a third-party offsetting the higher costs of a voluntary retirement programme.

There was investment in premises and new staff to support business expansion in Turkey, Russia and central and eastern Europe. In 2008, 112 new branches opened and staff numbers increased by 30 per cent in these markets.

Share of profit in associates and joint ventures declined by 84 per cent to US\$16 million with 2007

benefiting from an adjustment to the embedded value of HSBC Assurances. The absence of this gain was partially offset by increased joint venture profits following the sale of the card acquiring business in the UK.

2007 compared with 2006

Economic briefing

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

The expansion of the **eurozone** economy continued steadily in 2007, with GDP growth of 2.7 per cent. As in the UK, much of the momentum came from strength in business investment and exports as global demand remained strong, particularly from emerging markets. Consumption was relatively subdued, despite declining unemployment, although fiscal reforms (particularly in Germany) are believed to have depressed household expenditure. Eurozone inflation increased steadily during the second half of the year to an annual rate of 3.1 per cent in December, driven largely by rises in food and energy prices. The European Central Bank (["ECB"]) raised interest rates by 50 basis points during 2007, to finish the year at 4 per cent.

Review of business performance

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

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

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)*Geographical regions > Europe > 2007***Reconciliation of reported and underlying profit before tax**

2007 compared with 2006

Europe	2006 as reported US\$m	2006 acquisitions and disposals ¹ US\$m	Currency translation ² US\$m	2006 at 2007 exchange rates ⁶ US\$m	2007 acquisitions, disposals & dilution & gains ¹ US\$m	Under- lying change US\$m	2007 as reported US\$m	Re- ported change %	Under- lying change %
Net interest income	8,289	(3)	635	8,921	419	(1,594)	7,746	(7)	(1)
Net fee income	7,108	53	586	7,747	(133)	817	8,431	19	1
Other income ⁴	7,675	(53)	576	8,198	(90)	3,282	11,390	48	4
Net operating income ⁵	23,072	(3)	1,797	24,866	196	2,505	27,567	19	1
Loan impairment charges and other credit risk provisions	(2,155)	□	(147)	(2,302)	□	(240)	(2,542)	(18)	(1)
Net operating income	20,917	(3)	1,650	22,564	196	2,265	25,025	20	1
Operating expenses	(13,871)	2	(1,076)	(14,945)	(51)	(1,529)	(16,525)	(19)	(1)
Operating profit	7,046	(1)	574	7,619	145	736	8,500	21	1
Income/(expense) from associates	(72)	□	(6)	(78)	(50)	223	95	232	28
Profit before tax	6,974	(1)	568	7,541	95	959	8,595	23	1

For footnotes, see page 143.

In Commercial Banking, growth in deposit and lending balances in the UK and ongoing business expansion in Turkey and Malta led to steady growth in revenues. This was partly offset by increased loan impairment charges and higher costs associated with business expansion. In Global Banking and Markets, higher income from most businesses was offset by trading losses in Credit and Rates and increased costs. Strong profit growth in Private Banking was driven by an increased client appetite for discretionary portfolios, a rise in lending volumes and further improvements in cross-referrals. In Personal Financial Services, a fall in pre-tax profits reflected ex gratia payments expensed in respect of overdraft fees applied in previous years and a provision for reimbursement of certain charges on historic will trusts and other related services. The □Other□ segment benefited from a US\$1.3

billion fair value gain in HSBC's own debt.

Net interest income declined by 18 per cent, mainly because the expansion of trading activities in both the UK and France resulted in higher funding costs, with the related revenues reported in the trading income line. This was partly offset by higher net interest income in the personal and commercial businesses.

In the UK, Personal Financial Services' spreads widened in a rising interest rate environment and competitive pricing attracted higher balances. This was mitigated by lower spreads on mortgages as customers switched to fixed rate products. In

Commercial Banking, higher net interest income was largely driven by growth in the UK, Turkey, Germany and Malta. In the UK, a negotiated rate deposit product launched in previous years continued to be instrumental in driving higher deposit balances. Strong growth in corporate and structured banking for micro customers, together with expansion in lending to small and mid-market customers, contributed to higher lending balances although this benefit was partially constrained by spread compression in the competitive market.

Revenues from transactional balances held within the payments and cash management business increased by 13 per cent, as credit market dislocation in the second half of the year caused customers to hold higher cash balances. After several years of decline, balance sheet management revenues in Europe increased.

In Turkey, higher net interest income was driven by new customer acquisition. In Switzerland, the Private Banking business earned higher net interest income from lending to existing clients as they further leveraged their portfolios.

Net fee income rose by 11 per cent. Account services increased on higher customer balances and volumes of transactions in the UK and France, supported by sales of fee-earning packaged accounts. Card fees increased in the UK, mainly on interchange and acquiring fees, and in Turkey, on interchange and cash advance fees. This was partly offset by a reduction in credit card default fees in the

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UK following regulatory intervention by the OFT in 2006. Broking income increased in the UK, Germany and Switzerland, mainly driven by growth in client assets and transaction volumes. Funds under management fell on lower income from the Hermitage Fund following the part sale of HSBC's investment in it.

Trading income rose by 41 per cent, driven by the equities business and foreign exchange trading, where income increased strongly, with volume and profitability reflecting market volatility. The increase was partly offset by write-downs in credit, structured derivatives and leveraged and acquisition finance. Net trading income increased following the strategic decision to expand the collateralised lending and structured derivatives businesses, the funding costs of which are reported in net interest income.

Credit spreads, primarily on certain fixed-rate long-term debt issued by HSBC Holdings and its subsidiaries, widened significantly in the second half of 2007, leading to a sevenfold increase in *net income from financial instruments designated at fair value* compared with 2006. These cumulative gains will fully reverse over the life of the debt.

The sale of shareholdings and various equity investments in the UK and France, including Euronext (the European stock exchange), contributed to *gains from financial investments* of US\$1.3 billion, an increase of 101 per cent on 2006.

Net earned insurance premiums increased by 50 per cent to US\$4.0 billion, including growth of the Guaranteed Income Bond and motor insurance, and the introduction of enhanced death benefits to pension contracts in the UK. Premiums also grew in the UK because of a higher retention of risk in the non-life business compared with 2006, when a greater proportion of risk and corresponding premiums were ceded to reinsurers. There were also significant contributions from the reinsurance business in Ireland and the life assurance business in Malta.

Other operating income declined by 25 per cent. This largely resulted from a fall in the value of in-force business in UK insurance, driven by a change in the calculation methodology of the PVIF business in the first half of 2007 when HSBC implemented regulatory changes to the rules governing the

calculation of insurance liabilities. This had a marginally positive effect on profit as there was a corresponding reduction in policyholder liabilities.

Net insurance claims incurred and movement in liabilities to policyholders grew by 121 per cent to US\$3.5 billion. This growth, which paralleled the growth in net earned insurance premiums, included the effect of higher risk retention in the non-life business, although it was offset by FSA rule changes which led to lower claims valuations on life policies. There was also a rise in flood-related claims in the UK after record rainfalls during the summer.

Loan impairment charges rose by 10 per cent to US\$2.5 billion. Overall credit quality remained broadly stable. In the UK, loan impairment charges rose, primarily in consumer finance lending outside HSBC Bank; within HSBC Bank, steps taken in 2006 to tighten underwriting standards led to an improvement in loan impairment trends. Corporate loan impairment charges remained low in absolute terms, although they were 23 per cent higher than in 2006, principally reflecting the effect of Individual Voluntary Arrangements on micro businesses and impairments on two large corporate accounts in the UK.

Operating costs increased by 10 per cent to US\$16.5 billion, in line with the growth in net operating income before loan impairment charges. In the UK, a change in actuarial assumptions regarding the principal staff defined benefit pension scheme led to increased costs. Ex-gratia payments were expensed in respect of overdraft fees applied in previous years and a provision for reimbursement of certain charges on historic will trusts and other related services was raised which totalled US\$396 million. Cost increases also reflected investments in technology, higher payments and cash management transaction volumes, investments in the French structured derivatives business to support revenue growth and, in Turkey, technical infrastructure and additional headcount in support of business expansion.

Share of profit in associates and joint ventures rose by US\$167 million, largely as a result of a US\$73 million adjustment to the embedded value of HSBC Assurances in France prior to the acquisition of its remaining share capital, following which it was accounted for as a subsidiary.

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)*Geographical regions > Europe > Profit/(loss) before tax by customer group*

Analysis by customer group and global business

Profit/(loss) before tax

	2008						
Europe	Personal Financial Services US\$m	Commercial Banking US\$m	Global Banking & Markets US\$m	Private Banking US\$m	Other US\$m	Inter- segment elimination²¹ US\$m	Total US\$m
Net interest income/(expense)	6,464	3,435	3,488	1,046	(459)	(4,278)	9,696
Net fee income	2,612	2,025	1,763	1,020	72	□	7,492
Trading income/(expense) excluding net interest income	47	71	1,513	198	(138)	□	1,691
Net interest income/(expense) on trading activities	□	12	(655)	14	17	4,278	3,666
Net trading income/(expense) ¹⁶	47	83	858	212	(121)	4,278	5,357
Changes in fair value of long-term debt issued and related derivatives	□	□	□	□	2,939	□	2,939
Net income/(expense) from other financial instruments designated at fair value	(1,634)	(214)	(611)	□	633	□	(1,826)
Net income/(expense) from financial instruments designated at fair value	(1,634)	(214)	(611)	□	3,572	□	1,113
Gains less losses from financial investments	281	132	(30)	62	(27)	□	418
Dividend income	35	74	25	5	(9)	□	130

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Net earned insurance premiums	4,927	391	□	□	(19)	□	5,299
Gains on disposal of French regional banks	□	□	□	□	2,445	□	2,445
Other operating income	230	620	398	16	832	□	2,096
Total operating income	12,962	6,546	5,891	2,361	6,286	□	34,046
Net insurance claims ¹⁷	(3,224)	(143)	□	□	□	□	(3,367)
Net operating income⁵	9,738	6,403	5,891	2,361	6,286	□	30,679
Loan impairment charges and other credit risk provisions	(1,971)	(867)	(875)	(38)	(3)	□	(3,754)
Net operating income	7,767	5,536	5,016	2,323	6,283	□	26,925
Total operating expenses	(6,107)	(2,830)	(4,823)	(1,325)	(987)	□	(16,072)
Operating profit	1,660	2,706	193	998	5,296	□	10,853
Share of profit/(loss) in associates and joint ventures	(2)	16	2	□	□	□	16
Profit before tax	1,658	2,722	195	998	5,296	□	10,869
	%	%	%	%	%		%
Share of HSBC's profit before tax	17.8	29.2	2.1	10.7	56.9		116.7
Cost efficiency ratio	62.7	44.2	81.9	56.1	15.7		52.4
Balance sheet data ¹⁵	US\$m	US\$m	US\$m	US\$m	US\$m		US\$m
Loans and advances to customers (net)	126,909	87,245	185,818	25,722	497		426,191
Total assets	171,962	107,495	1,131,721	84,485	64,423	(217,075)	1,343,011
Customer accounts	145,411	91,188	199,687	66,007	183		502,476

For footnotes, see page 143.

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2007

Europe	Personal Financial Services US\$m	Commercial Banking US\$m	Global Banking & Markets US\$m	Private Banking US\$m	Other US\$m	Inter- segment elimination ²¹ US\$m	Total US\$m
Net interest income	6,604	3,419	1,361	793	86	(4,517)	7,746
Net fee income/(expense)	3,060	2,194	2,316	1,032	(171)	□	8,431
Trading income excluding net interest income	60	36	2,657	161	89	□	3,003
Net interest income/(expense) on trading activities	(7)	30	(610)	9	1	4,517	3,940
Net trading income ¹⁶	53	66	2,047	170	90	4,517	6,943
Changes in fair value of long- term debt issued and related derivatives	□	□	□	□	1,059	□	1,059
Net income/(expense) from other financial instruments designated at fair value	126	31	(185)	□	195	□	167
Net income/(expense) from financial instruments designated at fair value	126	31	(185)	□	1,254	□	1,226
Gains less losses from financial investments	50	36	1,100	115	25	□	1,326
Dividend income	1	4	155	7	4	□	171
Net earned insurance premiums	3,511	521	□	□	(22)	□	4,010
Other operating income/ (expense)	54	(35)	853	8	301	12	1,193
Total operating income	13,459	6,236	7,647	2,125	1,567	12	31,046
Net insurance claims ¹⁷	(3,214)	(265)	□	□	□	□	(3,479)
Net operating income ⁵	10,245	5,971	7,647	2,125	1,567	12	27,567
Loan impairment (charges)/recoveries and other credit risk provisions	(2,044)	(515)	26	(4)	(5)	□	(2,542)

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Net operating income	8,201	5,456	7,673	2,121	1,562	12	25,025
Total operating expenses	(6,635)	(2,941)	(5,150)	(1,208)	(579)	(12)	(16,525)
Operating profit	1,566	2,515	2,523	913	983	□	8,500
Share of profit in associates and joint ventures	15	1	4	2	73	□	95
Profit before tax	1,581	2,516	2,527	915	1,056	□	8,595
	%	%	%	%	%		%
Share of HSBC's profit before tax	6.5	10.4	10.4	3.8	4.4		35.5
Cost efficiency ratio	64.8	49.3	67.3	56.8	36.9		59.9
Balance sheet data ¹⁵	US\$m	US\$m	US\$m	US\$m	US\$m		US\$m
Loans and advances to customers (net)	151,687	106,846	163,066	30,195	481		452,275
Total assets	240,361	168,846	892,712	83,740	96,346	(245,372)	1,236,633
Customer accounts	178,757	99,704	163,713	62,055	725		504,954

For footnotes, see page 143.

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)*Geographical regions > Europe > Profit/(loss) before tax by customer group // Hong Kong*

Analysis by customer group and global business (continued)

Profit/(loss) before tax

2006

Europe	Personal Financial Services US\$m	Commercial Banking US\$m	Global Banking & Markets US\$m	Private Banking US\$m	Other US\$m	Inter- segment elimination ²¹ 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) ¹⁶	113	42	2,113	101	(38)	2,198	4,529
Changes in fair value of long-term debt issued and related derivatives	□	□	□	□	28	□	28
Net income/(expense) from other financial instruments designated at fair value	80	27	11	□	(2)	□	116
Net income/(expense) 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

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Other operating income	<u>128</u>	<u>103</u>	<u>957</u>	<u>13</u>	<u>256</u>	<u>(29)</u>	<u>1,428</u>
Total operating income	9,525	4,937	6,560	1,812	798	(29)	23,603
Net insurance claims ¹⁷	<u>(331)</u>	<u>(19)</u>	<u>□</u>	<u>□</u>	<u>(181)</u>	<u>□</u>	<u>(531)</u>
Net operating income ⁵	9,194	4,918	6,560	1,812	617	(29)	23,072
Loan impairment (charges)/recoveries and other credit risk provisions	<u>(1,838)</u>	<u>(386)</u>	<u>64</u>	<u>2</u>	<u>3</u>	<u>□</u>	<u>(2,155)</u>
Net operating income	7,356	4,532	6,624	1,814	620	(29)	20,917
Total operating expenses	<u>(5,447)</u>	<u>(2,298)</u>	<u>(4,224)</u>	<u>(1,010)</u>	<u>(921)</u>	<u>29</u>	<u>(13,871)</u>
Operating profit/(loss)	1,909	2,234	2,400	804	(301)	□	7,046
Share of profit/(loss) in associates and joint ventures	<u>□</u>	<u>□</u>	<u>(96)</u>	<u>1</u>	<u>23</u>	<u>□</u>	<u>(72)</u>